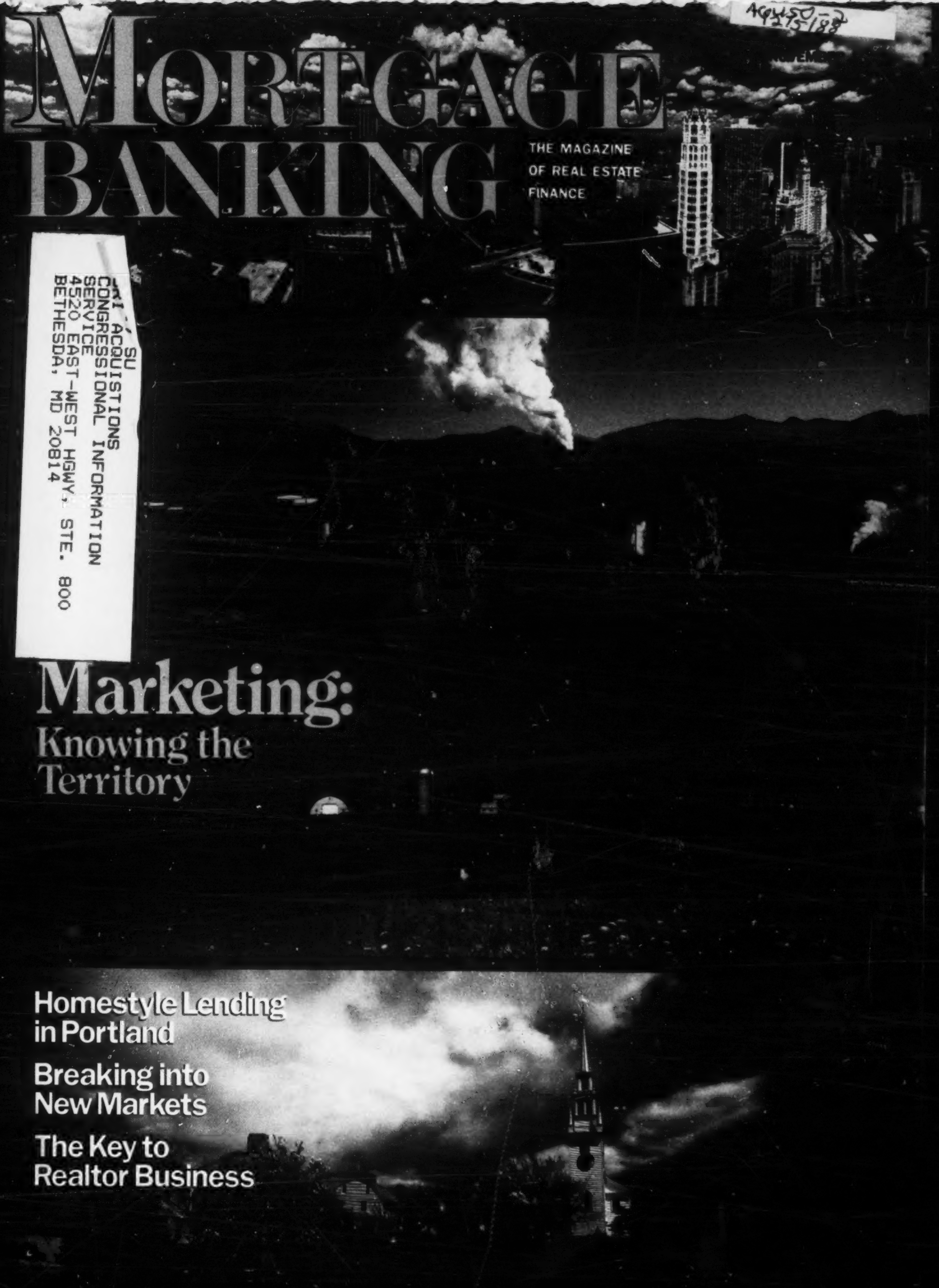

MORTGAGE BANKING

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Marketing:

Knowing the Territory

Homestyle Lending in Portland

Breaking into New Markets

The Key to Realtor Business

CONTENTS

NOVEMBER 1988 VOLUME 49 NUMBER 2

COVER:
Marketing: Knowing the Territory

Every mortgage lender would love to do more business. If there was a single formula for building mortgage market share—a one-loan-fits-all approach—mortgage banking would be a different business. Instead, lenders are faced with selling to a myriad of different consumers shaped by diverse regional preferences. Tailoring mortgage origination tactics to the home audience in each market is key to surviving and thriving in this year's crowded and competitive marketplace.

16 **Successful Lending in Your Own Backyard** Two partners demonstrate how to run a thriving one-office mortgage company in Portland, Oregon. The operating plan: concentrate on serving one market very well. RICHARD BRUNS

27 **Building Business Ties with Realtors** Realtors have a lot to say when you ask them what they do and don't like about lenders. Brokers appreciate straight talk about processing time and loan approval, but above all they like the lender that makes a deal fly. HOWARD SCHNEIDER

39 **Mortgage Markets: Speaking the Local Language** Some lessons mortgage lenders have learned when expanding into new markets. Culture shock can impair a loan officer's production numbers. SHARON GELTNER AND JANET REILLEY HEWITT

Strategy

48 **Strategic Planning at the Crossroad** A Wall Street expert counsels mortgage executives that corporate intuition is no substitute for a strategic plan. PATRICIA M. SHERLOCK

Roundtable

59 **Affordable Rental Housing: A Good View of the Playing Field** Finding a way to finance affordable rental housing is one of the thorniest policy issues of the day. A roundtable panel discusses possible solutions in this era of low-income housing constraints. LESLIE PLATT AND JOHN BOHM

Servicing

76 **Servicing: Staying Lonely Is a Sign of Success** No contact with the borrower is almost always a sign the servicing operation is working well. But that lost customer contact, and with it opportunities to cross-sell other products, is offset by other sound business reasons to invest in top-flight customer service in your loan administration unit. SUZANNE C. SAMSON, CMB

77 **Under Reconstruction—Making Servicing Portfolios Pay** Servicing managers need a strategy and a detailed plan for shaping their ideal portfolios. HERBERT L. CARREL, CMB

Insurance

82 **EDS Develops Computer Flood Program to Protect Lenders** Most borrowers with homes in high-risk flood zones aren't aware they could be in deep water. A system helps lenders identify the need for flood insurance. ANITA SEELIG

DEPARTMENTS

9 BOARDROOM VIEW
13 BUSINESS ALERT
95 THE SECONDARY MARKET
97 ECONOMIC TRENDS
102 INDEX TO ADVERTISERS

COVER BY MARK SEGAL AND J. McGRAIL

PORTFOLIO

Mortgage Market Geography

"Knowing the territory" means more than just being familiar with the lay of the land, or local real estate values, for mortgage bankers. It also means understanding the economic landscape. But in these times of volatile interest rates, the economic geography is hard to chart. It is easier, by far, to find a road map for local borrower preferences and origination volume by tapping the knowledge of local Realtors.

Although the industry's strategic planners start from the premise that lenders now operate in a single nationwide mortgage market, loan officers working the front lines know it is not that simple. Admittedly, there are some universal tenets that underlie the workings of all local mortgage markets. But there are just as many other local market nuances that make opening a new branch office a real pioneering venture, particularly in today's marketplace.

This month's cover report on marketing offers insights on what motivates real estate brokers to keep bringing business back to certain lenders. The issue also profiles the hands-on origination techniques that are working well for a small, one-office mortgage company in Portland, Oregon. The importance of speaking the same language as local Realtors and borrowers and having the right products is emphasized in a report about lenders who are breaking into new regional markets.

Strategic planning is critical to charting a profitable path through the less predictable economic and regulatory territory ahead. One article tells how to draw up a strategic plan for navigating those rocky roads. On the servicing front, an article probes ways to develop a management reporting system to direct servicing profitability and restructuring goals. Another features good business reasons for investing in a top quality servicing operation. Finding ways to help finance affordable rental housing is the tough issue on the table for discussion by a spectrum of experts. Boardroom View shares some ideas from CEOs who have found different ways to compensate loan officers.

Janet Reilley Hewitt
Editor

COMING IN DECEMBER

Missing Pieces of the Puzzle

After November's election, one major piece of the puzzle depicting future housing policy will be filled in. The next chief executive will set the course for key federal housing programs, such as the FHA, and the fate of full deductibility of mortgage interest, subsidized housing and the continued role of the secondary market agencies. In next month's issue, we will highlight likely housing policymakers in the next administration. The issue will also piece together the housing policy legacy of outgoing HUD Secretary Sam Pierce.

Editor's Note: **Mortgage Banking** is examining alternatives to its current mailing system to expedite delivery of issues to its subscribers. We understand that some subscribers have experienced delays in receipt of recent issues and we are taking steps to alleviate the problem. We appreciate your patience and assure you that preserving the timeliness of our publication is a top priority.

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Strategic Planning at the Crossroad

Intuitive judgment is no substitute for a well-constructed strategic analysis.

Patricia M. Sherlock

Mortgage bankers are at a crossroad. The glory days of the six-year bull market are at an end. Gone with that is the comfort zone of selling mortgages for a gain. Today, mortgage companies are faced with the harsh reality of an unfriendly market in a rapidly changing business environment.

Many mortgage firms have reacted to the new conditions by focusing solely on a single part of the business, such as risk management, production, or loan administration, as the answer to the unaccustomed dilemma of shrinking income levels. Frequently, this myopic approach overlooks the critical step of strategic analysis, a failure that must be avoided.

Through strategic analysis, management can: identify the new external realities a firm faces; review the internal functions and efficiencies of the company; and target future opportunities and risks (Chart 1).

Strategic analysis is generally regarded as a worthwhile exercise, but it is often ignored. The most commonly mentioned excuse for the failure to strategically plan is that of a too thinly spread management team trying to cope with daily emergencies. In an industry where one-third of the companies have fewer than 10 employees, planning can indeed seem like a luxury. However, the present realignment of the financial services sector has been so dynamic, and will continue to be so, that even smaller firms cannot afford to operate on corporate intuition and past successes. The current unforgiving business environment forces all mortgage companies—large and small—to probe every aspect of the marketplace in which they operate.

The initial step in strategic analysis involves two broad reviews:

- the external conditions encountered by a firm, including economic and regulatory factors; and,
- the intrinsic issues of competition and customer markets.

The results of the external and intrinsic reviews are then assessed against a firm's resources. The goal in strategic analysis is not to set unrealistic objectives, but to critique the external and intrinsic challenges and their potential impact, with the firm's strengths and resources. The bottomline result of this approach is the development of a strategy that will be shaped by market demands and within a firm's resources. A strategic analysis approach developed any other way tends to force the results and decrease the value of the review.

The strategic analysis discussion which occurs gives special emphasis to issues common to all mortgage bankers; but, each firm should address local variations and experiences when implementing its plan.

Two external conditions that should be examined in depth are the state of the financial marketplace and regulatory issues.

A key factor that impacts all mortgage lenders is the volatility of interest rates. Interest rate volatility had its origin in the regulatory and market changes of the 1970s. The deregulation of the financial services industry and the adoption of a quasi-monetarist approach by the Federal Reserve Board have increased rate volatility. In basic terms, monetarism emphasizes the money supply as the critical element the Fed watches in taking policy steps that determine interest rates. The net effect of this approach has been to let interest rates rise to whatever level is required to meet targeted money supply growth ranges. One result of a targeted money supply program is a tendency to have dramatic rate swings and volatility. A further complication encouraged by a monetarist approach is a tendency by both investors and sellers to stay on the short end of the yield curve, which adds to rate volatility.

Chart 2 illustrates the market's volatility during the 1982-1988 bull

ILLUSTRATION BY LINA CHESAK

market for the benchmark, 10-year U.S. Treasury bond. While Treasury rates declined overall in that six-year period, impressive rate movement was a frequent occurrence, throughout the bull market era. Mortgage bankers remember only too well the dramatic rate swing experienced in April and October 1987. From a strategic planning perspective, the key question is: Will rate volatility continue? And if so, what will it mean for mortgage bankers?

The Fed has followed a monetarist approach for more than a decade and there is no indication that this general approach will be altered. As a result, mortgage bankers' pipeline and servicing portfolios will continue to experience dramatic interest rate shifts. The difference, during the next few years, will be a decreased margin for errors, given the end of the bull market. Thus, the future success of a mortgage company will be tied to how well it can manage in a bear market with high rate volatility. One example of a strategic issue that will need to be addressed in this unfriendly market scenario will be the viability of offering "free" rate-locks to borrowers. Only companies with substantial capital cushions will be able to survive with such an operating strategy.

Another major external condition that should be addressed is the regulatory environment. Historically, mortgage finance has been a political matter in the U.S. There is no reason to anticipate this will change in the near future or that governmental involvement will lessen.

The broader issue that mortgage bankers should explore is the speed and impact of future deregulation in the financial services sector. The continued erosion of the Glass-Steagall Act barriers, the disappearance of branching restrictions on depository institutions and the removal of distinctions between banks and thrifts will all increase the rate of entry of firms into the mortgage arena. The mortgage banking business will continue to be attractive to these players because of the fragmentation of the market and the potential for economies of scale. Furthermore, the mortgage banker's niche as the main provider of fixed-rate mortgages to borrowers pales in an environment of asset securitization. Fixed-rate products, which had been the nemesis of the thrift industry, are no longer such a threat when they can be packaged and sold into the secondary market.

The key issue in a further deregulated marketplace will likely be market share. A market share driven industry will place a higher value on functional efficiencies: a lean and mean organization will be the required operating mode in the 1990s.

Another area to be examined in the strategic analysis plan is the intrinsic or micro issues. Competition and market demand for mortgage finance products are important factors to be addressed. Several trends have evolved which suggest strong competition and a realignment of mortgage firms. Competition in mortgage lending has intensified due to financial sector deregulation. While there are approximately more than 30,000 institutions with mortgage lending franchises, only 7,600 firms are meaningful mortgage lenders[1]. In 1987, the top 25 largest residential mortgage (Table 1) servicers held 25 percent of the market share and had begun to increase their share. It appears that the mortgage industry is dividing into two groups—large and small players.

This division between the large and small firms is reflected in a market trend of consolidation. Strategically, consolidation in the mortgage industry is part of the larger trend of the shrinkage in the number of financial service firms. The merging process will accelerate as financial firms contend with narrowing interest margins and escalating operating costs. One estimate is that between 10 percent and 48 percent of financial firms in existence today will disappear in the next five to ten years.

Strategic analysis is generally regarded as a worthwhile exercise, but it is often ignored.

A report published in *American Banker*[2] projects that consolidation of financial institutions has many similarities to what occurred in the retail merchandising industry. Grocery stores and gas stations experienced rapid growth between 1963-1972, but after hitting a saturation point, they consolidated. Today there are fewer branch outlets in that industry than in 1954. Presently, 20 percent of all gasoline is sold through non-branch outlets such as convenience stores. There is a sobering analogy here for mortgage lenders.

Another critical issue for strategic planners in the mortgage industry is the slackening demand for home loans. For many firms that expanded to serve the record volumes of 1986 and 1987, the current year has brought home the reality of lower mortgage volume. The key strategic planning issue is whether this is a long-term trend.

It is important to recognize that the surge of mortgage volume in 1985 and 1986 was largely due to the tremendous amount of refinancing. Currently, only 5 percent of the total mortgage-backed securities outstanding are premium coupons, which reduces the potential number of refinancing customers.[3] It seems realistic, therefore, to project future-year reduced mortgage volume.

The traditional analytical method used to forecast demand for residential mortgage volume is housing stock and household formation projections. For obvious reasons, demographic projections, specifically household formation figures are linked with the supply of housing and the demand for mortgage finance. If the current pattern of household formation continues, housing market volume in the 1990s

CHART 1

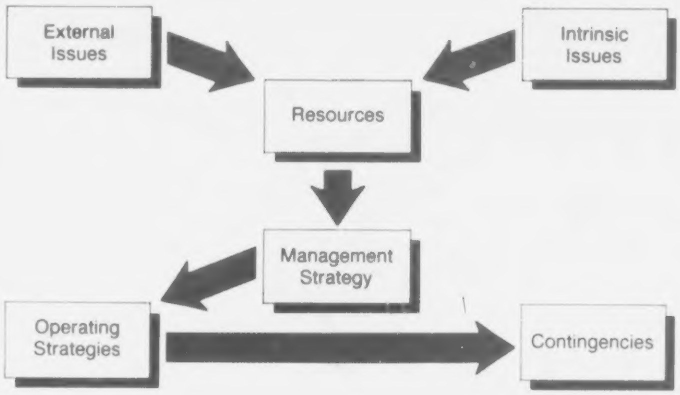
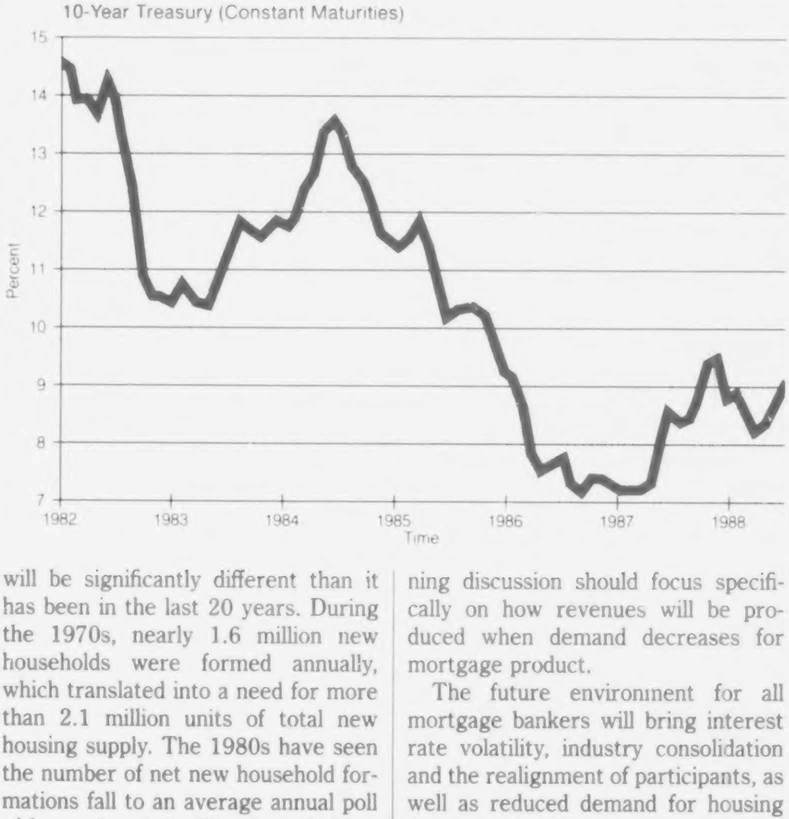


CHART 2

Volatility



will be significantly different than it has been in the last 20 years. During the 1970s, nearly 1.6 million new households were formed annually, which translated into a need for more than 2.1 million units of total new housing supply. The 1980s have seen the number of net new household formations fall to an average annual poll of fewer than 1.3 million households a year. With that drop has come a corresponding shrinkage in the total housing supply to less than 1.8 million new units. The projected number of net new households formed will average only about one million a year in the 1990s, implying further shrinkage in the total new housing supply.[4]

The significant decline in household formation will have a major impact on mortgage bankers. The strategic planning discussion should focus specifically on how revenues will be produced when demand decreases for mortgage product.

The future environment for all mortgage bankers will bring interest rate volatility, industry consolidation and the realignment of participants, as well as reduced demand for housing finance.

So what should lenders do to plan for this difficult business environment?

The next stage of strategic thinking involves determining how the firm will allot its resources under the new conditions. Before a firm devises operating strategies, management should assess five options. These strategic alternatives include: keeping your market share; growing selectively, diversifying, allowing the business to decline, or exiting from the business.

These five options are the core alternatives of a company's investment strategy. The goal of the investment strategy is to select the business activity that generates the highest return on the investment. Before the investment decision is made, it is necessary to analyze the status and position of the mortgage company against the external and intrinsic factors already mentioned. The review process will then create an attractiveness assessment that management matches with its position in the marketplace. It should be recognized that a firm's strength may not complement the external and intrinsic forces. From this assessment, a primary thrust develops that becomes the future focus of the business. For example, a full-service mortgage firm may determine that secondary marketing skills are its forte, servicing is a secondary strength, and origination capability is last. The firm decides that, with continued volatility, hedging skills will be in demand and offer greater potential rewards than risk.

The first and easiest strategy to maintain is the status quo. This strategy may be appropriate for a firm with a significant market share that is a player in a given market and still moving up the growth curve. For the full-service mortgage banker with top secondary marketing skills, "the hold your own strategy" is not desirable, given the firm's view of the market and the company's strengths.

The second strategic alternative is to grow selectively. This approach involves entering or refocusing on markets related to the firm's existing business. Our hypothetical mortgage banker may want to participate in the income property market as an adjunct to its residential lending efforts. Opening offices in growth markets may be another alternative to weigh. But the fixed costs involved may make this strategy unattractive. Our mortgage banker may want to de-emphasize the retail approach, and implement a wholesale lending strategy, playing off its secondary and servicing skills. Each firm must analyze its capital structure and resources before electing this change.

The third alternative is to diversify from present markets. Diversification should be pursued if management de-

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termines that present market demand will not furnish the growth the company needs to be profitable. But the mortgage banker in the previously mentioned example has not decided that the mortgage sector is unattractive. So this alternative would be eliminated in that firm's strategic planning.

The fourth option is to let the mortgage company operation phase out and sell off related assets. This mode generates cash back to the parent to be invested in other more profitable sectors. Our mortgage banker may decide to sell off offices in stages allowing the implementation of a wholesale strategy. The challenge in this approach is that the selected pruning may turn into a full-fledged sell-off eroding prospects for getting the best price for the assets. Finally, the firm may decide to exit the business.

Once an investment strategy has been selected, management would next develop operating strategies to implement the new thrust of the firm. The operating strategies would establish milestones, specific programs and contingencies for when targets are missed.

The goals should be translated into result objectives for sales, market share and profit numbers.

As in any endeavor, the strategic plan should cover potential problems or contingencies that may arise. These problems could center on obstacles or trigger points, which would necessitate a change in the operating assumptions. An example of a significant change would be if interest rates rose to 20 percent. A 20 percent interest rate market would obviously have drastic repercussions on housing, as well as the external and intrinsic assumptions included in the strategic plan.

The strategic planning process supplies management the ultimate risk management tool. It is crucial for a firm to implement a strategic planning program as part of their management activities. To manage without one is like operating a ship without a rudder. It is critical that management perform this analysis because they know their firm best. The challenges facing mortgage bankers today are so complex that relying on gut reactions, at the expense of careful strategic planning, is a likely ticket for failure. **MB**

TABLE 1

Top 25 Companies in Mortgage Servicing, 1987

		12/31/87
1	Citicorp Mortgage Inc., St Louis, MO	$44,400,000,000
2	GMAC Mortgage Co., Elkins Park, PA	24,497,123,407
3	Lomas & Nettleton Financial Corp., Dallas, TX	21,672,114,657
4	CityFed Mortgage Co., Bellevue, WA	19,651,141,000
5	Fireman's Fund Mortgage Corp., Farmington Hills, MI	17,912,142,270
6	Fleet Mortgage Corp., Milwaukee, WI	14,617,594,124
7	Metmor Financial, Inc., Los Angeles, CA	13,818,110,325
8	Goldome Realty Credit Corp., Buffalo, NY	13,665,275,000
9	Commonwealth Mortgage Corp. of America, Houston, TX	12,980,598,000
10	BancBoston Mortgage Companies, Inc., Jacksonville, FL	12,380,000,000
11	Weyerhaeuser Mortgage Co., Los Angeles, CA	10,888,113,914
12	First Union Mortgage Corp., Charlotte, NC	10,801,000,000
13	Sears Mortgage Corp., Lincolnshire, IL	10,568,243,767
14	Fleet Real Estate Funding Corp., Florence, SC	9,956,581,903
15	Shearson Lehman Mortgage Corp., Irvine, CA	9,653,079,257
16	First Interstate Mortgage Co., Pasadena, CA	8,861,000,000
17	Chemical Mortgage Corp., Columbus, OH	8,563,000,000
18	BancPlus Mortgage Corp., San Antonio, TX	8,083,119,000
19	Knutson Mortgage Corp., Bloomington, MN	7,952,599,634
20	Countrywide Funding Corp., Pasadena, CA	7,951,963,000
21	Chase Home Mortgage Corp., Montvale, NJ	7,745,360,000
22	Sovran Mortgage Corp., Richmond, VA	7,207,860,950
23	Imco Realty Services, Inc., Santa Rosa, CA	6,973,328,967
24	Anchor Mortgage Services, Inc., Wayne, NJ	6,828,783,468
25	Empire of America Realty Credit Corp., Buffalo, NY	5,922,000,000

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[1] Data gathered by SMR Research Corp., Budd Lake, NJ. SMR is a publishing and consulting firm.
[2] Bert Ely, *American Banker*, March 18, 1988.
[3] 12 percent and up coupons—GNMA, FNMA and FHLMC.
[4] Richard F. Hohenson, *Demographics: Profiles of a Changing Society*, Donaldson Lufkin & Jenrette Securities Corp., 1988.

Patricia M. Sherlock is an investment banker at a major Wall Street firm, specializing in financial institutions. She is an adjunct professor for the Real Estate Institute at New York University, and also instructs a school for mortgage pipeline management.

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES, BY UNIT TYPE

(Units in thousands)

YEAR AND MONTH	HOUSING STARTS						PERMITS 17,000 ISSUING PLACES					
	Actual			Seasonally Adjusted Annual Rates			Actual			Seasonally Adjusted Annual Rates		
	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units
1988												
MAR	129	105	24	1,529	1,229	300	140	107	33	1,476	1,110	366
APR	154	112	42	1,584	1,151	433	137	100	37	1,449	1,035	414
MAY	140	109	31	1,393	1,056	337	137	105	32	1,436	1,058	378
JUN	150	119	31	1,465	1,154	311	154	114	40	1,493	1,081	412
JUL	138	105	33	1,485	1,115	370	121	92	29	1,420	1,063	357
AUG$_p$	**135**	**109**	**26**	**1,436**	**1,147**	**289**	**135**	**103**	**32**	**1,447**	**1,095**	**352**
1987 TOTAL	1,620	1,211	409				1,535	1,114	421			
1986 TOTAL	1,805	1,263	542				1,770	1,186	584			
8 MONTHS												
1988	1,014	786	228				991	747	244			
1987	1,125	848	277				1,079	793	286			
1986	1,274	888	386				1,161	744	417			
1985	1,176	805	371				1,213	821	392			

RESIDENTIAL STRUCTURES BY REGION

(Units in thousands)

YEAR AND MONTH	HOUSING STARTS								PERMITS 17,000 ISSUING PLACES							
	Actual				Seasonally Adjusted Annual Rates				Actual				Seasonally Adjusted Annual Rates			
	North East	Mid-West	South	West	North East	Mid-West	South	West	North East	Mid-West	South	West	North East	Mid-West	South	West
1988																
MAR	22	18	53	36	290	262	572	405	26	24	54	37	306	276	525	369
APR	25	32	59	37	265	345	595	379	25	28	48	38	265	272	512	400
MAY	20	30	54	36	200	269	562	362	23	29	49	36	236	274	538	388
JUN	26	32	55	37	241	263	584	377	26	30	57	41	247	282	574	390
JUL	25	29	49	35	261	290	563	371	20	24	44	34	225	255	546	394
AUG$_p$	**22**	**25**	**49**	**39**	**207**	**240**	**565**	**424**	**21**	**25**	**49**	**40**	**216**	**249**	**555**	**427**
1987 TOTAL	269	298	634	420					272	282	575	406				
1986 TOTAL	294	296	733	483					283	290	687	510				
8 MONTHS																
1988	167	184	393	269					164	179	373	274				
1987	184	204	437	300					188	194	407	289				
1986	199	204	530	341					189	194	487	343				
1985	159	159	535	324					171	156	509	325				

HOUSING ACTIVITY (Cont'd.)

YEAR AND MONTH	HOUSING SALES (Units in thousands)				VALUE OF NEW CONSTRUCTION PUT IN PLACE (Dollars in billions)				CONSTRUCTION STATUS (Units in thousands)					
	EXISTING HOUSES[1]	NEW HOMES			Seasonally Adjusted Annual Rate				Seasonally Adjusted Annual Rate Under Construction			Completions		
	Sold	Sold	Available For Sale	Months Supply at Current Rate	Total	1 Unit	2+ Units	Non-res	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units
1988														
MAR	303	68	366	6.8	232.4	117.6	21.6	93.2	999	658	341	121	86	35
APR	322	68	362	6.6	233.0	117.4	21.1	94.5	999	661	338	126	87	39
MAY	344	64	367	6.7	232.5	116.2	21.4	94.9	984	646	338	115	88	27
JUN	379	64	367	6.3	231.0	115.4	21.4	94.2	984	650	334	134	102	32
JUL	331	58	365	6.3	228.7	114.4	21.9	92.4	981	648	333	129	96	33
AUG$_p$	**363**	**59**	**368**	**6.3**	**228.3**	**115.6**	**22.0**	**90.7**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**
1987 TOTAL	3,520	671										1,669	1,194	475
1986 TOTAL	3,565	750										1,756	1,206	550
8 MONTHS														
1988	2,453	480										n.a.	n.a.	n.a.
1987	2,471	487										1,091	759	332
1986	2,389	535										1,110	751	359
1985	2,170	484										1,089	736	353

LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED

By Type of Institution and By Unit Type

(Dollars in millions)

YEAR AND MONTH	TOTAL					1-4 UNITS				
	Total	Mtg. Bankers[9]	S&Ls	Banks[2]	Life Cos	Total	Mtg. Bankers[9]	S&Ls	Banks[2]	Life Cos
1987										
DEC	$ 52,632	$ 6,794	$ 16,617	$ 24,833	$ 4,388	$ 29,464	$ 6,582	$ 12,238	$ 10,530	$ 114
1988										
JAN	36,953	5,919	10,683	18,765	1,586	21,139	5,742	8,327	7,038	32
FEB	35,487	5,886	10,924	17,021	1,656	20,634	5,440	8,507	6,626	61
MAR	42,582	6,878	14,394	19,386	1,924	26,343	6,638	11,575	7,984	146
APR	44,532	7,000	15,228	19,972	2,332	28,082	6,702	12,668	8,547	165
MAY$_p$	**51,696**	**7,581**	**17,460**	**24,143**	**2,512**	**32,816**	**7,277**	**14,568**	**10.849**	**122**
1987 TOTAL	648,148	115,373	210,358	286,789	35,628	445,434	110,093	173,822	158,257	3,262
1986 TOTAL	633,959	142,884	218,118	235,514	37,443	450,232	131,628	176,073	138,717	3,814
5 MONTHS										
1988	211,250	33,264	68,689	99,287	10,010	129,014	31,799	55,645	41,044	526
1987	278,028	62,925	86,546	117,034	11,523	204,000	60,199	72,542	69,738	1,521
1986	179,487	41,529	68,621	58,481	10,856	130,016	38,668	54,896	35,309	1,143
1985	121,787	22,541	51,964	38,948	8,334	81,021	20,950	38,673	21,089	309

LENDER ACTIVITY (Cont'd.)

LONG-TERM MORTGAGE LOANS CLOSED (Cont'd.)

(Dollars in millions)

YEAR AND MONTH	5+ UNITS					NONRESIDENTIAL				
	Total	Mtg Bankers	S&Ls	Banks	Life Cos	Total	Mtg Bankers	S&Ls	Banks	Life Cos
1987										
DEC	$ 3,371	$ 97	$ 1,986	$ 969	$ 319	$ 19,797	$ 115	$ 2,393	$ 13,334	$ 3,955
1988										
JAN	2,122	160	1,171	710	81	13,692	17	1,185	11,017	1,473
FEB	2,020	385	990	421	224	12,833	61	1,427	9,974	1,371
MAR	2,387	157	1,349	658	223	13,852	83	1,470	10,744	1,555
APR	2,589	270	1,233	656	430	13,861	28	1,327	10,769	1,737
MAY$_p$	**3,157**	**256**	**1,495**	**1,024**	**382**	**15,723**	**48**	**1,397**	**12,270**	**2,008**
1987 TOTAL	36,735	2,409	17,719	12,887	3,720	165,979	2,871	18,817	115,645	28,646
1986 TOTAL	40,449	7,172	19,877	9,677	3,723	143,278	4,084	22,168	87,120	29,906
5 MONTHS										
1988	12,275	1,228	6,238	3,469	1,340	69,961	237	6,806	54,774	8,144
1987	14,927	942	6,890	5,914	1,181	59,101	1,784	7,114	41,382	8,821
1986	11,358	1,602	6,263	2,306	1,187	38,113	1,259	7,462	20,866	8,526
1985	9,019	792	5,237	2,218	772	31,747	799	8,054	15,641	7,253

LONG-TERM COMMITMENT ACTIVITY

By Type of Institution

(Dollars in millions)

YEAR AND MONTH	ISSUED DURING MONTH					OUTSTANDING				
	Total	Mtg Bankers	S&Ls	Banks	Life Cos	Total	Mtg Bankers	S&Ls	Banks	Life Cos.
1987										
DEC	$ 26,649	$ 2,907	$ 15,561	$ 6,170	$ 2,011	$111,370	$ 6,711	$44,927	$46,613	$13,119
1988										
JAN	28,343	7,271	13,929	5,618	1,525	106,598	8,111	41,990	43,325	13,172
FEB	27,456	4,490	13,525	6,598	2,843	110,839	9,147	43,049	44,404	14,239
MAR	37,484	3,969	18,742	10,858	3,915	117,502	7,453	45,589	48,532	15,928
APR	36,435	3,569	19,895	9,421	3,550	126,301	7,972	47,067	54,091	17,171
MAY$_p$	**41,486**	**5,698**	**22,300**	**10,164**	**3,324**	**130,198**	**10,418**	**49,233**	**52,997**	**17,550**
1987 TOTAL	475,252	96,534	235,457	110,306	32,955					
1986 TOTAL	532,999	128,480	231,915	133,504	39,100					
5 MONTHS										
1988	168,194	21,997	88,391	42,659	15,147					
1987	221,281	52,612	102,492	51,752	14,425					
1986	212,352	52,874	89,810	50,657	18,811					
1985	117,479	18,525	63,981	22,918	12,055					

MORTGAGE INSURANCE

(Units in thousands, Dollars in millions)

YEAR AND MONTH	APPLICATIONS RECEIVED (Units)				LOANS INSURED							
	Total	FHA	VA	Private	Total		FHA		VA		Private	
					Units	Amt.	Units	Amt.	Units	Amt.	Units	Amt.
1988												
MAR	175	109	15	51	98	7,036	49	2,927	19	1,381	30	2,728
APR	165	93	14	58	88	6,591	42	2,508	14	1,039	32	3,044
MAY	170	91	18	61	113	8,222	59	3,545	16	1,164	38	3,513
JUN	168	85	20	63	111	8,466	50	3,006	16	1,209	45	4,251
JUL	148	75	18	55	130	9,565	72	4,383	17	1,287	41	3,895
AUG$_p$	**162**	**85**	**22**	**55**	**128**	**9,588**	**66**	**4,069**	**19**	**1,451**	**43**	**4,068**
1987 TOTAL	2,341	1,211	409	721	2,278	159,373	1,315	81,553	452	33,315	511	44,505
1986 TOTAL	3,279	1,907	450	922	1,853	127,758	921	56,901	346	24,719	586	46,138
8 MONTHS												
1988	1,127	623	124	380	771	56,711	394	23,789	121	9,034	256	23,888
1987	1,888	1,050	322	516	1,681	118,285	984	62,476	344	25,248	353	30,561
1986	1,494	581	284	629	1,127	77,076	558	34,059	199	14,205	370	28,812
1985	1,121	248	151	722	834	54,165	235	13,333	112	7,568	487	33,264

SECONDARY MARKET ACTIVITY

(Dollars in millions)

YEAR AND MONTH	FNMA Portfolio Comm	FNMA Portfolio Purc	FNMA Mortgage-Backed Securities Outstanding	FNMA Mortgage-Backed Securities Issued	FHLMC* Comm to Sell	FHLMC* Comm to Buy	FHLMC* Mtg Purc	FHLMC* Mtg Sold	GNMA Pass-Through Securities Applications	GNMA Pass-Through Securities Issued
1988										
MAR	$ 3,823	$ 2,776	$145,242	$ 3,352	$ 2,973	$ 4,262	$ 2,932	$ 2,312	$ 3,458	$ 3,106
APR	2,555	2,409	149,569	5,444	2,968	6,437	2,772	2,266	4,820	3,315
MAY	2,142	2,108	152,826	4,600	3,552	5,159	2,876	2,325	6,288	4,168
JUN	2,179	2,372	157,438	6,220	4,288	6,447	4,117	3,649	4,964	5,570
JUL	1,108	1,960	160,636	4,895	3,445	5,328	3,879	4,116	5,514	6,348
AUG$_p$	**1,041**	**1,638**	**163,253**	**4,261**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**6,517**	**6,285**
1987 TOTAL	25,415	20,531		63,230	68,210	76,615	76,840	75,018	116,611	96,983
1986 TOTAL	32,987	30,826		60,566	107,209	136,179	103,474	102,431	152,911	98,169
8 MONTHS										
1988	15,364	15,922		31,962	n.a.	n.a.	n.a.	n.a.	36,906	36,281
1987	15,993	12,468		46,251	57,303	61,918	63,225	61,806	89,947	75,478
1986	23,281	17,539		36,544	66,726	70,866	58,255	55,821	82,023	53,352
1985	13,799	14,719		11,933	28,689	31,569	26,802	24,088	39,097	25,901

*In December, master commitment conversions exceeded new master & regular commitments taken.

INTEREST RATES AND YIELDS

1- to 4-UNIT MORTGAGES

YEAR AND MONTH	FHA OPINION SURVEY FHA New[3]	FHA OPINION SURVEY CONVENTIONAL New	FHA OPINION SURVEY CONVENTIONAL Existing	FHLBB SURVEY CONVENTIONAL New	FHLBB SURVEY CONVENTIONAL Existing	FNMA 1 Yr. ARM (1%/Yr.)	FNMA FRM Conv.
1987							
MAR	10.28%	9.99%	10.01%	9.15%	9.14%	8.60%	9.74%
APR	10.46	10.19	10.19	9.13	9.21	8.86	10.04
MAY	10.65	10.48	10.49	8.95	9.19	9.36	10.36
JUN	10.75	10.35	10.37	9.26	9.28	9.45	10.22
JUL	10.66	10.47	10.47	9.17	9.32	9.70	10.26
AUG	10.70	10.55	10.56	9.07	9.34	10.10	10.49
SEP$_p$	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**9.98**	**10.48**

CURRENT SECONDARY MARKET YIELDS / SELECTED SECURITIES

YEAR AND MONTH	CURRENT SECONDARY MARKET YIELDS GNMA[4]	CURRENT SECONDARY MARKET YIELDS FNMA[4]	CURRENT SECONDARY MARKET YIELDS FHLMC[5]	SELECTED SECURITIES A-Rated[7] Utility	SELECTED SECURITIES U.S. Government 10-yr.	SELECTED SECURITIES U.S. Government 26-wk.	SELECTED SECURITIES Prime Comm. Paper 90-119 Days
1988							
MAR	9.39%	9.33%	9.29%	9.91%	8.37%	5.91%	6.62%
APR	9.72	9.62	9.59	10.23	8.72	6.21	6.86
MAY	10.01	10.56	10.25	10.61	9.09	6.53	7.19
JUN	9.97	10.10	10.06	10.41	8.92	6.71	7.49
JUL	9.96	10.31	10.27	10.40	9.06	6.99	7.82
AUG	10.13	10.45	10.41	10.45	9.26	7.39	8.26
SEP	**9.94**	**10.13**	**10.11**	**10.26**	**8.98**	**7.43**	**8.17**

SPREADS (Basis Points)

YEAR AND MONTH	FHA New Minus A-Utility	GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
1988				
FEB	11	108	106	102
MAR	37	102	96	92
APR	23	100	90	87
MAY	23	92	147	116
JUN	34	105	118	114
JUL	26	90	125	121
AUG	25	87	119	115
SEP	**n.a.**	**96**	**115**	**113**

NA—Not available. p—Preliminary.

[1] From the National Association of Realtors, "Existing Home Sales," series.

[2] Mutual Savings Banks and Commercial Banks.

[3] FHA applications received includes the Direct Endorsement Program starting in 1984.

[4] Secondary market gross yields.

[5] Federal Home Loan Mortgage Corp. Existing Construction only.

[6] Securities for 0 to 30 day delivery.

[7] Prior to January 1984 this rate was for Aaa rated New Issue Utility Bonds.

[8] Year to date seasonally adjusted series not calculated.

[9] 1985 data on mortgage bankers obtained from the HUD Survey of Mortgage Lending Activity.

MORTGAGE BANKING

THE MAG

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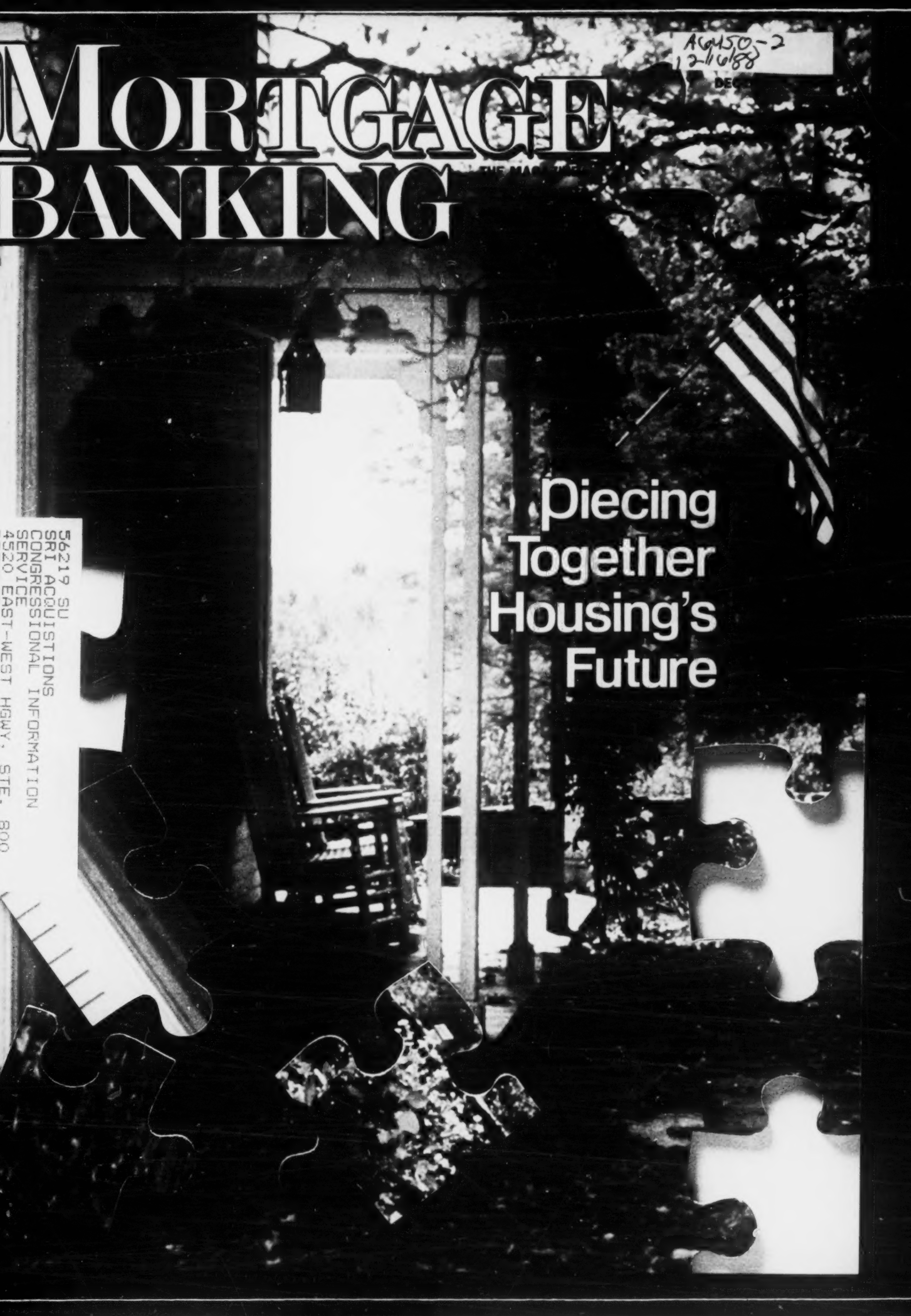

Piecing Together Housing's Future

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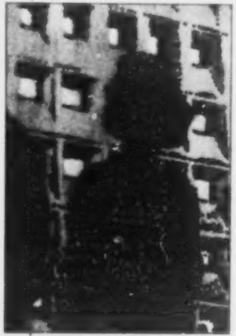
CONTENTS

DECEMBER 1988 VOLUME 49 NUMBER 4

Cover: Piecing Together Housing's Future

This is a critical transition time for America's housing policy. Yet, the names and faces of key officials who will shape the direction of that policy are still unknown. President-elect Bush and his transition team are quickly filling in missing pieces of the puzzle that depicts who the major domestic policymakers will be in his administration. But the exact shape of the finished housing policy depends on how other pieces of the puzzle fall into place. Those last, hard-to-fit pieces are not likely to find a final resting place until the ink is dry on a final budget compromise that Congress approves.



14 **The Battle for President Bush's Housing Soul** The people chosen to head the key federal government housing programs will tell a lot about housing priorities in the Bush administration. By JOSEPH C. DAWSON

23 **Reagan Years** The housing policy legacy of the Reagan administration reflects the hard choices dictated by budget deficits. Yet, despite some policy differences with the outgoing administration, the mortgage banking industry enjoyed some record years during the Reagan era. By BILL BLACK

Legislative

28 **The Cornerstone to Expanding Homeownership** Is broadening the reach of the FHA program the answer to the growing affordability problem? Some in the housing industry say yes, others are not convinced.
By BRIAN J. CHAPPELLE

Regulatory

39 **Unlocking the Door for First-time Buyers** Most states have a program to channel below-market mortgage financing to first-time homebuyers. These programs can be new profit opportunities for lenders. By DIANE L. CORTES

44 **Regulatory Roadblock—California's Licensing Dilemma** The mortgage banking business has long been operating on a nationwide scope but some state laws hamper its smooth operation across state lines.
By WILLIAM F. MACK

Insurance

52 **Weighing the Risk of Self-Insurance** The factors linked to foreclosure risk are spelled out in this guide to help lenders decide if self-insuring is a too risky business. By TERRANCE M. CLAURETIE AND JOHN B. CORGEL

Income Property

63 **The Workout Group** Loan workout departments are playing an increasingly important role in preserving lenders' bottom lines. Some well-run ones have even become independent profit centers. By EVERETT S. COVINGTON

Executive Essay

71 **Loan Officers—An Endangered Species?** The moment of truth has come for pondering the future of the loan officer. With lenders turning away from retail, the traditional commission is being re-examined. By JOHN J. JACOBS IV

Legal Opinion

74 **The Illinois Foreclosure Act—Still an Albatross** A legal opinion on why the latest revisions to the Illinois foreclosure law fell short of the goal of improving the version that was on the books. By LEE SCOTT PERRES AND BARRY FISHER

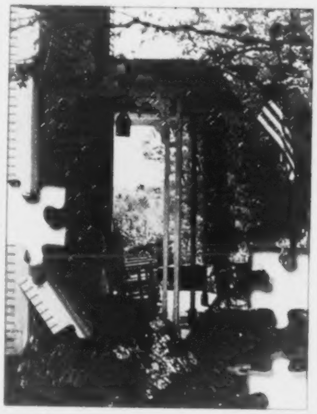
DEPARTMENTS

9 BOARDROOM VIEW
11 BUSINESS ALERT
78 PEOPLE
81 THE SECONDARY MARKET
83 ECONOMIC TRENDS
88 INDEX TO ADVERTISERS

COVER PHOTOGRAPHY BY BOB GROVE

PORTFOLIO

Housing Policy in Transition



An audible sigh of relief is in the air around Washington these days. A new president is preparing to take the helm and although much is not known about his housing agenda he is sending at least one hopeful signal to the housing community. What is the message Mr. Bush has been articulating that could bring so much potential good cheer: It's that deficits do matter.

In other times, that would seem an unbelievably trite message to raise hopes so high. But in the wake of the Reagan dogma, a pragmatic man in the White House is indeed a sign that holds promise. The Bush housing agenda is still somewhat veiled in mystery. But if genuine progress is made on reducing budget deficits, that will be a big plus for housing because lower rates are sure to follow.

This month's issue probes the choices the new occupant of the White House has before him, as far as key housing advisors and policy. We couple this look ahead with a look back at the past eight years of housing policy. The acute problem of housing affordability will be a major focus in the 101st Congress. A National Housing Task Force has proposed expanding the FHA program in ways to help tackle the affordability problem and we examine the merits of that approach. Finally, lenders can find new profit opportunities in state and local tax-exempt mortgage bond programs that the 100th Congress revived just before adjourning.

We close out this turbulent year for mortgage bankers with a little food for thought. Our executive essay ponders the pressures that are reshaping the way loan officers of the future will be compensated.

Janet Reilley Hewitt
Editor

COMING IN JANUARY

The Great Paper Chase

Ginnie Mae issuers have been chasing down missing loan documents to meet the looming January deadline for getting uncertified Ginnie Mae pools finally certified. Next month's issue will have some of the horror stories on pools that seem to defy certification and what issuers have done to wrestle them into submission. We will hear from custodians, Ginnie Mae President Mark Buchman, issuers, lawyers and consultants on how the industry is tackling the certification and recertification problem.

MORTGAGE BANKING
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As Congress takes up the affordability debate, FHA becomes a key focus.

The Cornerstone to Expanding Homeownership

As housing affordability becomes an increasingly severe problem, Congress has been exploring alternatives to help increase the rate of homeownership in America.

A major focal point for this discussion has been the recommendations of the National Housing Task Force commissioned by Senators Alan Cranston and Alfonse D'Amato. The task force maintains, as does MBA, that a strong and viable FHA can play a critical role in expanding homeownership opportunities.

Before discussing the specific recommendations, it is appropriate to point out the role FHA has played during its 50-year history. MBA believes FHA policy over the years has been totally consistent with its mission and essential to the continual functioning of the housing finance system in many parts of the country. This is an important point as the chief critics of FHA maintain it has strayed from its fundamental mission.

Throughout its history, FHA has effectively served more than 15 million homebuyers by blending its fundamental social purpose of expanding homeownership opportunities with prudent fiscal responsibility. This management philosophy has enabled FHA to assist many families who otherwise could not have purchased a home. At the same time, it has allowed FHA to accumulate about $4 billion in reserves.

In this regard, it must be remembered that FHA administers an insurance program. Like any successful insurance company, FHA must adhere to fundamental insurance principles that include the pooling of risks of possible loss across a large enough group to minimize the losses that inevitably will occur.

Within this basic framework, FHA insurance has allowed lenders to offer more liberal terms to low- moderate- and middle-income borrowers, greatly expanding the number of families who can afford to purchase homes. Amortization of loans over longer periods and lower cash investments are two examples of how FHA experience transformed mortgage lending practices and opened up homeownership opportunities.

While the Mortgage Insurance Companies of America (MICA) maintains that FHA should serve only low-income families, that view indicates a lack of awareness of the ingredients behind FHA's formula for success. Because FHA (Section 203(b)) is an insurance program that operates at no expense to the taxpayer, it is essential that FHA have a broad base of borrow-

Brian Chappelle

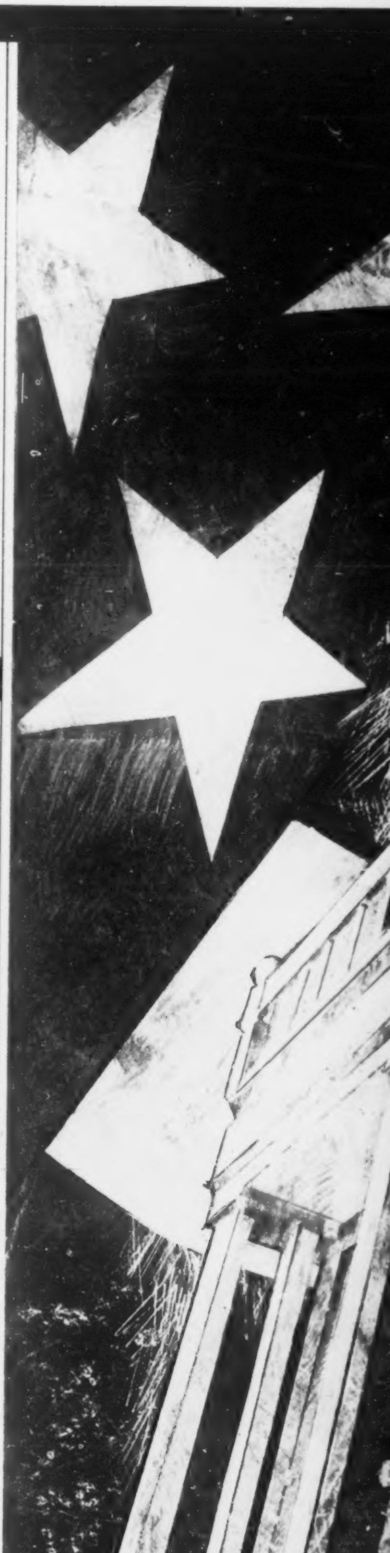

ILLUSTRATION BY STEVEN LEE HOSKINS

ers over which to spread its insurance risk. By its very nature, FHA insurance benefits some, at the expense of other, borrowers. In fact, through HUD's uniform premium structure, one group of borrowers actually subsidizes the homeownership opportunities of high-risk, lower-income borrowers. For that reason, no mention of income limits or any references to the income of Section 203(b) borrowers is made throughout that section of the National Housing Act.

This is not to say that FHA should operate unbridled in the marketplace. FHA has always followed reasonable mortgage limits to target its loans. In fact, contrary to the implied arguments of FHA's opponents, FHA's mortgage limits are lower today than they were 20 years ago on a relative basis, compared to national, existing housing, average sales prices.

In the last several years, we have seen another example of the importance of FHA to the marketplace. Because of the success that private insurers enjoyed in the 1970s as a result of the seemingly risk-free environment of high inflation and appreciation in home values, they were questioning the need for FHA in 1981.

At that time, in response to higher interest rates, the conventional mortgage finance industry embraced alternative mortgage instruments involving negative amortization and adjustable interest rates, with unrealistic first year "teaser" rates and no caps. These untested instruments, coupled with liberal underwriting guidelines, enabled the MI industry to serve the same market of borrowers that FHA served for several years.

Once the shortcomings of this strategy began surfacing in the form of foreclosures, MIs reassessed their position. (See Moody's Investor Services' annual report for 1986 for documentation as to the severity of the problem.) In response to these unprecedented losses, MIs re-evaluated their risk management operations, and the end result has been a considerable tightening of underwriting requirements. Some examples of changes include the following:

- Lower expense-to-income ratios especially for loans with 91 to 95 percent LTVs.
- Imposition of geographic limitations (i.e. no investor loans or tighter underwriting requirements in economically depressed areas).
- Mandatory borrower cash investment (i.e. gift letters only for down payments above 5 percent).
- Cash on hand after closing to pay at least two months' mortgage payments.

One only has to talk with state housing finance agency officials to understand the impact of these changes and the retrenchment of the MI industry. A survey of 10 state housing agencies, revealed each agency has been compelled to rely heavily, if not entirely, on FHA in the last several years to meet the housing needs of lower-income families. MIs have almost totally withdrawn from the state housing programs.

> **If FHA had not been there to keep the housing industry viable in these states, homeownership opportunities would have been virtually nonexistent for average Americans.**

In addition to the almost universal concern expressed by state housing agencies, we have witnessed considerable tightening of MI guidelines in the economically distressed areas of Texas, Oklahoma, Colorado, Louisiana, and Alaska. MBA fully understands the reason for this shift in management philosophy. But the MI's sound business strategy further underscores the importance of FHA. If FHA had not been there to keep the housing industry viable in these states, homeownership opportunities would have been virtually nonexistent for average Americans lacking the down payment and income necessary to meet extremely rigorous underwriting guidelines.

However, that commitment by FHA has not occurred without a price. FHA has incurred a significant portion of their recent claim problems in states where MIs have retreated for prudent business reasons.

The task force identified the problem of raising money for a down payment as probably the principal impediment to buying a home for many low-, moderate- and middle-income families. Because a low down payment is one primary benefit of the FHA program, improvements to the Federal Housing Administration make it the ideal vehicle to carry out the recommendations of the task force. Specific recommendations for building on the FHA program to achieve some of the task force's goals are discussed.

Adjustable rate mortgage instruments were developed in response to the affordability crunch created by rising interest rates in the early 1980s. While there were problems with early ARM instruments as we noted earlier, the development of effective consumer protection measures has made these instruments reasonable alternatives for many borrowers. As the task force points out, ARM mortgages can have initial rates 2 or 3 percent below fixed-rate instruments. However, because of limitations in the FHA ARM program (1 percent cap on annual adjustments), borrowers lacking the additional down payment or income required for conventional ARM mortgages are denied access to this instrument and the lower relative interest rates under this program. For these reasons, MBA supports the task force recommendations to raise the cap on an annual adjustment from 1 to 2 percent a year, remove the cap on activity, and require HUD analysis of whether additional consumer protection measures are needed. MBA also supports raising the lifetime cap from 5 to 6 percent to make the FHA ARM consistent with the industry standard.

With regard to the potential adverse impact of an increase in the annual cap to 2 percent on certain borrowers, MBA agrees that 2 percent adjustments are not for every FHA borrower. As the servicer of the vast majority of FHA loans, mortgage bankers are all too familiar with the problems created for borrowers by defaults and foreclosures, not to mention the financial expenses for the lender. Additional underwriting protection must be built into the loan origination process of these products (e.g. underwrite at the maximum second-year rate). In this way, eligible borrowers are protected against unnecessary risk and thousands of homebuyers who do not have the down payment for a conventional loan will be able to take advantage of this instrument, just as higher income families do with conventional ARM loans.

MBA believes that the current FHA mortgage limits have restricted FHA from serving many homebuyers, particularly in high-cost areas. We have prepared a chart comparing average sales prices for existing housing with the FHA maximum mortgage limits. (The years chosen correspond with years that the FHA mortgage limits were raised.)

Chart 1 shows that contrary to the charge made by critics that FHA limits have increased too often, FHA mortgage limits have dropped dramatically over the last 20 years as a percentage of average sales price. In 1969, the FHA mortgage ceiling was more than 50 percent higher than the average sales price. While the National Association of Realtors has maintained this data only since 1968, we believe that same relationship existed throughout FHA's earlier years.

While Congress has partially responded to this problem by raising the ceiling in high-cost areas up to a maximum of $101,250, even in those areas the maximum mortgage amount equates only to 95 percent of the median sales price. In high-cost areas where the median sales price far exceeds the $101,250 ceiling, the problem is exacerbated because that arbitrary ceiling may be only 80 percent of the average sales price in places like California, New England, New York and Washington, D.C. As a result, MBA believes that the task force's proposal of removing the $101,250 limit is clearly justified and would bring FHA mortgage limits more in line with historical limits.

As the task force notes, down payments are probably the most significant impediment to homeownership. In response to this problem, the task force proposes lowering down payments by $500 on homes costing over $50,000, thus raising the portion of the property's value that would have a 3 percent down payment from $25,000 to $50,000. MBA believes this modest change will ease the burden of accumulating the necessary cash investment, while not seriously affecting borrower motivation to continue making payments. This change recognizes the fact that there are more and more borrowers who have the income to meet their monthly obligations, but simply lack the cash reserves to make the needed down payment.

Accepting high loan-to-value ratio loans has not adversely affected the actuarial soundness of the FHA program. In 1987, MBA commissioned a study by Peat, Marwick and Main which concluded that the FHA insurance fund is in good financial condition. In fact, the study also concluded that the current mortgage insurance premium of 3.8 percent could be lowered to 3.4 percent based on FHA's own actuarial standards. The soundness of the FHA program was verified by an FHA study earlier this year.

But, in its testimony on the task force's recommendations, MICA raised concerns about the status of the

CHART 1

Year	Existing Housing Average Sales Price	FHA Mortgage Ceiling	FHA ceiling as percent of average sales price
1969	$21,800	$33,000	151%
1974	$32,000	$45,000	141%
1977	$42,900	$60,000	140%
1979	$55,100	$67,500 ($90,000 in high-cost area)	123%*
1988	$85,600 (1987 data)	$67,500 ($101,250 in high-cost area)	79%*

* For areas above $67,500 and below the high-cost area maximum, the limit would be approximately 95 percent.

CHART 2

1985 Originations

	Claims*	Mortgages Insured	Percent Claims
Texas	3,923	41,197	9.5%
Oklahoma	1,190	7,795	15.3%
Louisiana	604	5,867	10.3%
Colorado	2,065	26,602	7.8%
Wyoming	116	1,467	7.9%
Alaska	765	2,500	30.6%
Total (Oil States)	8,663	85,425	10.1%
Remainder of Country	11,377	366,099	3.1%
U.S. Total	20,040	451,524	4.4%

* Through December 1987

Oil states comprised 19 percent of HUD's originations and 43 percent of HUD's claims in 1985.

CHART 3

1986 Originations

	Claims*	Mortgages Insured	Percent Claims
Texas	2,264	81,320	2.8%
Oklahoma	466	18,627	2.5%
Louisiana	200	15,711	1.3%
Colorado	1,012	56,864	1.8%
Wyoming	77	3,972	1.9%
Alaska	312	4,850	6.4%
Total (Oil States)	4,331	181,344	2.4%
Remainder of Country	3,790	749,823	.5%
U.S. Total	8,121	931,167	.9%

* Through December 1987

CHART 4

**Market Share of Total Originations
(In Percent)**

	FHA				MIs			
	1984	1985	1986	1987	1984	1985	1986	1987
Alaska	10	27	38	43	80	39	24	12
Colorado	21	29	32	45	27	13	6	6
Florida	6	9	12	17	48	30	12	10
Louisana	6	10	16	23	33	22	9	7
Oklahoma	10	15	22	32	40	23	8	6
Texas	7	14	18	35	44	24	11	10
Six State Total	9	15	19	29	43	24	11	9

Note Based on new business per state in dollars divided by total originations per state in dollars

Sources for table MI production figures from MICA FHA production as reported by HUD Total originations as estimated by HUD

Mutual Mortgage Insurance Fund, which includes FHA's Section 203(b) program. MBA is also concerned about the continued strength of that fund. For that reason, MBA has introduced a variety of actions to reduce FHA's risk exposure that have since been implemented by the FHA. For example, MBA recommended the termination of the Section 245(b) graduated payment mortgage program that allowed negative amortization above the original value of the property. MBA also proposed reducing the maximum loan-to-value ratio to 75 percent for investor-owned loans. Both changes have subsequently been enacted by the Congress. Because MBA recognizes the importance of actuarial soundness to the on-going success of FHA, we will continue to analyze the claim situation in an effort to make improvements to the fund's status.

Based on current analysis, there are two points MBA believes are essential to mention regarding FHA's recent claim experience. They are:

- The importance of location on claims experience.

In the last several years, we have watched the "oil patch" states endure tremendous economic distress. These economic hard times have resulted in unprecedented claim problems for all segments of the lending community, regardless of loan criteria (e.g. low loan-to-value ratios). A look at their impact on FHA originations in 1985 and 1986 documents this problem. (See charts 2 and 3.)

While the oil states' share of HUD's originations stayed constant in 1986 at 19 percent, their share of claims rose to 53 percent. As these numbers show, the problem is far more complicated than very high ratio loans and less stringent underwriting criteria. The easy answer would be for FHA to stop making loans in economically distressed areas. But we believe the devastation to these areas would be exacerbated by such an action, since FHA is the major, if not only, viable insurance source in these hard-hit regions.

A look at recent FHA and MI new origination information underscores this problem. FHA's market share has risen from 9 percent in 1984 to 29 percent in 1987 in six key states (Texas, Alaska, Colorado, Louisiana, Oklahoma and Florida). At the same time, MI market share in these states dropped from 43 percent to 9 percent over the same period. Chart 4 highlights this change.

As FHA fills market voids left by the MI retrenchment, increased risk becomes an inevitable result. The risk associated with problem markets is emerging as a key determinant in determining future claim losses, regardless of loan underwriting standards.

- Recent FHA business quality.

Because of the tremendous loan volume in the last several years (over 40 percent of FHA's portfolio was originated in 1986 and 1987), FHA's actuarial managers are looking at the quality of these more recent mortgages as an indication of FHA's future actuarial soundness. In this regard, FHA's 1986 book of business had the lowest first-year claim rate of any year in the 15-year period analyzed. As the data indicates, it would have been even better without the economic problems suffered in the Southwest. We believe there are two key reasons for this improvement.

Tighter underwriting and better quality control procedures—Much like the rest of the industry, FHA acted in the mid-1980s to address problems that required changes in its program guidelines. FHA implemented an early default tracking system to monitor lender performance. They also substantially increased the number of staff (from 10 to 35) that visit lenders and review loan quality and compliance with HUD guidelines. HUD implemented a variety of underwriting changes that MBA supports (e.g. buydown restrictions, assumption processing, tighter underwriting criteria for shared equity loans and use of residual income only as compensating factor). MBA believes these changes have all contributed to improved claim performance.

Better loan quality—Because of the unprecedented drop in interest rates in 1986, many homeowners refinanced existing FHA mortgages with new mortgages at lower interest rates. While this is probably only a one-time phenomenon, the net result is to greatly improve the quality of FHA's portfolio. These borrowers, who paid the same premium amount as high-risk, low-income borrowers buying their first homes, will help offset the program costs of serving riskier, lower-income buyers. MICA's response to this development has, on the other hand, been to recommend excluding refinances from FHA's program.

The success of the FHA has surely exceeded its founders' expectations. MBA supports the initiatives of the National Housing Task Force to ensure that FHA continues to serve the needs of the American homebuyer. The task force and MBA believe enhancements to FHA can be the cornerstone of the federal government's effort to expand homeownership opportunities. Adopting the changes recommended by the task force, would allow FHA to continue to flourish and ensure that homeownership remains possible for low-, moderate- and middle-income families at no cost to the taxpayer. **MB**

Brian Chappelle is senior director of single-family housing at MBA.

VITAL STATISTICS

INTEREST RATES & YIELDS

1- TO 4-FAMILY MORTGAGES

	FHA OPINION SURVEY	FHLBB			FNMA		FHLMC	
		CONVENTIONAL[2]						
1988	FHA New Homes[1]	FRM	ARM	Median Cost of Funds FSLIC Institutions	1-Yr. ARM	FRM Conv.	ARMs	FRMs
JUN	10.75%	10.35%	8.39%	7.11%	8.45%	10.22%	7.85%	10.46%
JUL	10.66	10.50	8.44	7.14	8.70	10.26	7.84	10.43
AUG	10.70	10.56	8.47	7.21	9.10	10.49	8.01	10.60
SEP	**10.66**	**10.66**	**8.52**	**NA**	**8.99**	**10.25**	**8.14**	**10.48**

SELECTED SECURITIES

1988	FEDERAL FUNDS RATE	PRIME COMMERCIAL PAPER (3-Month)	U.S. GOVERNMENT				A-Rated Utility
			6-Month	1-Year	3-Year	10-Year	
JUL	7.75%	7.82%	6.99%	7.75%	8.44%	9.06%	10.40%
AUG	8.01	8.26	7.39	8.17	8.77	9.26	10.45
SEP	8.19	8.17	7.43	8.09	8.57	8.98	10.26
OCT	**8.30**	**8.24**	**7.50**	**8.11**	**8.43**	**8.80**	**10.11**

CURRENT SECONDARY MARKET YIELDS

1988	GNMA[3]	FNMA[3]	FHLMC[3]
JUL	10.17%	10.13%	10.09%
AUG	10.30	10.27	10.24
SEP	10.11	10.09	10.06
OCT	**9.96**	**9.97**	**9.95**

SPREADS

(Basis Points)

1988	GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
JUL	111	107	103
AUG	104	101	98
SEP	113	111	108
OCT	**116**	**117**	**115**

SECONDARY MARKET ACTIVITY

(Dollars in Millions)

	FNMA				FHLMC				GNMA	
	Portfolio		Mortgage-Backed Securities						Pass-Through Securities	
1988	Commitments	Purchases	Out-Standing	Issued	Commitments To Sell	Commitments To Buy	Mortgages Purchased	Mortgages Sold	Applications	Issued
JUN	$2,179	$2,372	$157,438	$6,220	$4,288	$6,447	$4,117	$3,648	$4,964	$5,570
JUL	1,108	1,960	160,636	4,895	3,445	5,328	3,879	4,116	5,514	6,306
AUG	1,041	1,638	163,253	4,261	4,095	2,822	3,858	3,719	6,517	6,327
SEP	**1,439**	**1,111**	**167,170**	**5,622**	**NA**	**NA**	**NA**	**NA**	**5,975**	**5,684**
1987 TOTAL	25,415	20,531	---	63,230	68,210	76,615	76,840	75,018	116,611	96,983
1986 TOTAL	32,987	30,826	---	60,566	107,209	136,179	103,474	102,431	152,911	98,169
9 MONTH AVG.[4]										
1988	2,117	2,033	---	4,363	3,161	4,904	3,237	2,829	4,765	4,663
1987	1,982	1,579	---	5,593	7,163	7,740	7,903	7,726	11,824	9,091
1986	3,059	2,462	---	4,878	8,345	11,733	7,282	6,978	13,262	7,357

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES

(Units in Thousands, Seasonally Adjusted Annual Rates)

	BY TYPE OF UNIT						BY REGION							
	HOUSING STARTS			BUILDING PERMITS			HOUSING STARTS				BUILDING PERMITS			
1988	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units	Northeast	Midwest	South	West	Northeast	Midwest	South	West
JUN	1,465	1,154	311	1,493	1,081	412	241	263	584	377	247	282	574	390
JUL	1,477	1,119	358	1,420	1,063	357	257	285	562	373	225	255	546	394
AUG	1,431	1,136	295	1,464	1,096	368	204	239	563	426	215	253	562	434
SEP	**1,453**	**1,113**	**340**	**1,399**	**1,057**	**342**	**212**	**254**	**552**	**435**	**189**	**251**	**547**	**412**
1987 TOTAL	1,621	1,212	409	1,535	1,114	421	269	298	634	420	272	282	575	406
1986 TOTAL	1,805	1,263	542	1,769	1,186	584	294	296	733	483	283	290	687	510
9 MONTH AVG. (SAAR)														
1988	1,470	1,132	338	1,424	1,063	361	253	267	561	389	245	262	531	386
1987	1,668	1,248	420	1,581	1,147	433	280	317	637	432	281	300	586	414
1986	1,844	1,274	571	1,781	1,184	597	304	298	760	482	284	291	711	495

HOME SALES

(Units in Thousands)

	EXISTING HOMES			NEW HOMES		
1988	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate
JUN	3,820	2,700	8.5	718	367	6.2
JUL	3,630	2,500	8.3	700	364	6.4
AUG	3,710	2,500	8.2	715	363	6.3
SEP	**3,630**	**2,400**	**8.0**	**659**	**364**	**6.9**
1987 TOTAL	3,526	---	---	671	---	---
1986 TOTAL	3,565	---	---	750	---	---
9 MONTH AVG. (SAAR)						
1988	3,517	---	---	672	---	---
1987	3,571	---	---	687	---	---
1986	3,467	---	---	757	---	---

VALUE OF NEW PRIVATE CONSTRUCTION PUT IN PLACE

(Units in Billions of 1982 Dollars, Seasonally Adjusted Annual Rates)

1988	Total[5]	1−Unit	2+ Units	Nonresidential
JUN	$276.7	$102.5	$19.0	$79.1
JUL	279.5	101.3	19.3	77.2
AUG	281.1	102.2	19.1	77.0
SEP	**281.8**	**103.3**	**19.3**	**76.6**
1987 TOTAL	283.0	100.7	22.4	78.2
1986 TOTAL	281.8	92.0	28.0	79.8
9 MONTH AVG. (SAAR)				
1988	279.2	102.7	19.4	77.7
1987	281.4	99.6	22.7	77.2
1986	279.5	89.5	27.8	80.4

LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED By Type of Institution and By Type of Unit

(Dollars in Millions)

	1-4 UNITS					5+ UNITS					NONRESIDENTIAL				
1988	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies
MAR	$26,698	$6,638	$13,059	$6,500	$146	$2,544	$157	$1,471	$536	$223	$14,297	$83	$1,914	$10,300	$1,555
APR	28,420	6,702	14,153	7,062	165	2,744	270	1,475	414	430	14,276	28	1,619	10,477	1,737
MAY	33,300	7,277	16,518	8,899	253	3,253	256	1,636	883	323	16,654	48	1,872	11,795	2,802
JUN	**41,638**	**9,914**	**20,031**	**10,934**	**367**	**3,925**	**593**	**2,167**	**711**	**288**	**15,721**	**63**	**2,256**	**10,551**	**2,742**
1987 TOTAL	449,544	110,093	208,054	124,551	3,209	44,981	2,409	22,492	8,299	3,547	168,652	2,871	25,613	110,490	28,160
1986 TOTAL	455,054	131,628	207,182	108,613	3,814	49,868	7,172	22,769	7,176	3,723	147,374	4,084	27,306	83,929	29,906
6 MONTH AVG. 1988	28,740	6,952	13,871	7,404	171	2,819	304	1,553	544	262	14,621	50	1,835	10,563	1,947
1987	42,066	11,635	18,281	11,572	309	4,279	204	1,823	843	246	12,430	335	1,993	8,177	1,834
1986	30,034	8,809	14,284	6,401	225	3,364	446	1,450	423	253	9,481	253	1,920	5,206	1,917

MORTGAGE INSURANCE

(Units in Thousands, Dollars in Millions)

1988	APPLICATIONS RECEIVED (Units)				LOANS INSURED							
	TOTAL	FHA[8]	VA	PRIVATE	TOTAL		FHA		VA		PRIVATE	
					Units	Amount	Units	Amount	Units	Amount	Units	Amount
JUN	168	85	20	63	111	$8,466	50	$3,006	16	$1,209	45	$4,251
JUL	147	75	18	55	130	9,565	72	4,383	17	1,287	41	3,895
AUG	162	85	22	55	129	9,588	66	4,070	19	1,451	43	4,068
SEP	**141**	**72**	**19**	**50**	**117**	**8,732**	**59**	**3,655**	**20**	**1,505**	**38**	**3,572**
1987 TOTAL	2,340	1,211	408	721	2,282	159,668	1,320	81,881	451	33,312	511	44,475
1986 TOTAL	3,281	1,907	450	923	1,853	127,757	921	56,901	346	24,718	586	46,138
9 MONTH AVG. 1988	153	84	17	52	112	8,187	58	3,544	17	1,298	36	3,345
1987	220	118	39	63	209	14,561	123	7,665	42	3,082	44	3,814
1986	291	174	37	79	147	10,075	71	4,374	27	1,964	48	3,737

NA—Not Available; SAAR—Seasonally Adjusted Annual Rate

[1] Secondary market gross yields. Numbers shown for each month are the average of yields from the first day of the month shown and the first day of the subsequent month.

[2] Effective rate on loans closed.

[3] Securities for 0 to 30 day delivery.

[4] Average covers one month less for FHLMC.

[5] In addition to the categories of private construction shown, the total also includes these categories: residential improvements, railroads, electric light and power, gas, telephone and telegraph, petroleum pipelines, and farm nonresidential.

[6] In addition to the categories shown, the total also includes private pension funds, private MBS conduits, state and local retirement funds, Federal credit agencies, mortgage pools, and state and local investment agencies.

[7] Savings & Loans and Mutual Savings Banks.

[8] FHA applications received includes the Direct Endorsement Program.

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CONTENTS

JANUARY 1989 VOLUME 49 NUMBER 4

COVER: Document Deadline

Paperwork is the bane of most people's existence. But mortgage documents are the building blocks that the entire secondary market rests upon. During the refinance boom of 1986-87, some of the key legal paperwork that makes up a loan file got a rush job. That faulty paperwork showed up in title insurance policies, mortgage insurance certificates and even in recorded deeds. Finally, in an attempt to crackdown on the lingering stack of older pools with faulty documents, Ginnie Mae set a deadline for getting pools finally certified. That document deadline is now upon us.

14 **Paper Chase** Issuers tackled their uncertified Ginnie Mae pools with some degree of success in the face of a January enforcement deadline. Ginnie Mae signaled when loan buy-outs would be required. By CHARLES L. ADAMS AND JANET REILLEY HEWITT

26 **Custodians: Coming Into the Limelight** Ginnie Mae document custodians felt the paperwork crunch as the deadline for final certifications neared. By JANET REILLEY HEWITT

37 **Final Certification** Ginnie Mae's top official explains why the crackdown on uncertified pools was necessary. By MARK E. BUCHMAN

Servicing 40 **Let's Say Goodbye to Rodney** A new aggressive management approach has arrived in the servicing department. The watchword is efficiency. By ROBERT R. DENSMORE

Management 46 **Adam Smith's Message** The father of free-market economists—Adam Smith—could have been writing about today's mortgage markets when he said that the free hand of competition works to the benefit of consumers but puts the squeeze on profit margins. By LEON T. KENDALL

Socio-economics 55 **Keeping Up the Neighborhood** Mortgage bankers have good business reasons for making their markets a good place to call home. By JOSEPH C. DAWSON

Income Property 62 **Construction Lending: Risks and Returns** Tips on how to negotiate the risky terrain of construction lending. By HENRY S. KESLER, CMB

Regulatory 73 **Regulatory Facts of Life** Mortgage bankers are bumping up against more and more regulatory obstacles at the state and federal level. These remain in the forecast for tomorrow's mortgage players. By PETER E. KAPLAN

Servicing 83 **Servicing: Do You Run A Quality Shop?** Steps for setting up a comprehensive quality control plan in your servicing department. By ALAN J. KAPPELER

Index 87 **1988 Article Index** A listing of last year's articles by author/title and subject. By CASSIE KUPSTAS

DEPARTMENTS

8 LETTERS
11 BOARDROOM VIEW
13 BUSINESS ALERT
97 PEOPLE
99 THE SECONDARY MARKET
101 ECONOMIC TRENDS
106 INDEX TO ADVERTISERS

COVER PHOTOGRAPHY BY BOB GROVE

Message for a New Year

When one thinks about currently overworked terms in the industry, quality control ranks near the top. But there hardly could be a more critical concept in mortgage banking these days.

What may be news, however, is that the need for quality control extends equally from the front-end of the business to the often overlooked, back-end of the operation where the key documents are assembled for mortgages backing a Ginnie Mae pool.

Quality control on the production side of the business became critical when investors started demanding buybacks and indemnifications for claims on loans that violated the letter of the investor's law. That was a pocketbook issue. But the need for improved quality control in the pool documentation area was a lesson only thoroughly learned in 1988. Again, it was the pocketbook that figured into the learning curve, and a directive from Ginnie Mae setting a deadline for getting older pools finally certified. That combination triggered a scramble for old loan documents that shook up issuer's back-office operations for much of last year.

But the industry responded positively to the new deadline that takes effect this month. It now appears that a renewed commitment to quality control has rippled all the way down through every aspect of the business. That leaves the industry in a good position to greet the coming of a new year.

This issue also reviews a new attitude of cost-consciousness in the servicing department. The unfettered competition now squeezing profit margins to the bone is conforming to Adam Smith's eighteenth century economic formula—leaving the consumer as the sole beneficiary, one of our authors notes. Not news to anyone in the business is the fact that the "unregulated" world of mortgage banking is becoming more regulated than ever. An article reviews that on-going trend and another offering examines the civic-business reasons that mortgage bankers get involved with promoting growth and housing in their communities.

Janet Reilley Hewitt
Editor

COMING IN FEBRUARY

Mortgage Finance Meets the Supercomputer

Next month's cover story will focus on how MBS research departments on Wall Street are shaping the kinds of mortgages that get offered to the average borrower on the street. MBS research department heads talk about how they use supercomputers and million dollar software models to determine pricing and prepayment factors for certain types of originations.

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VITAL STATISTICS

INTEREST RATES & YIELDS

1- TO 4-FAMILY MORTGAGES

1988	FHA OPINION SURVEY	FHLBB			FNMA		FHLMC	
	FHA New Homes[1]	CONVENTIONAL[2] FRM	ARM	Median Cost of Funds FSLIC Institutions	1-Yr. ARM	FRM Conv.	ARMs	FRMs
JUL	10.66%	10.50%	8.44%	7.14%	8.70%	10.26%	7.84%	10.43%
AUG	10.70	10.56	8.47	7.21	9.10	10.49	8.01	10.60
SEP	10.66	10.64	8.51	7.21	8.99	10.25	8.14	10.48
OCT	**10.41**	**10.69**	**8.58**	**NA**	**8.86**	**9.97**	**8.12**	**10.30**

SELECTED SECURITIES

1988	FEDERAL FUNDS RATE	PRIME COMMERCIAL PAPER (3-Month)	U.S. GOVERNMENT 6-Month	1-Year	3-Year	10-Year	A-Rated Utility
AUG	8.01%	8.26%	7.39%	8.17%	8.77%	9.26%	10.45%
SEP	8.19	8.17	7.43	8.09	8.57	8.98	10.26
OCT	8.30	8.24	7.50	8.11	8.43	8.80	10.11
NOV	**8.35**	**8.66**	**7.86**	**8.48**	**8.72**	**8.96**	**10.12**

CURRENT SECONDARY MARKET YIELDS

SPREADS

(Basis Points)

1988	GNMA[3]	FNMA[3]	FHLMC[3]	GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
AUG	10.30%	10.27%	10.24%	104	101	98
SEP	10.11	10.09	10.06	113	111	108
OCT	9.96	9.97	9.95	116	117	115
NOV	**9.98**	**9.91**	**9.89**	**102**	**95**	**93**

SECONDARY MARKET ACTIVITY

(Dollars in Millions)

1988	FNMA				FHLMC				GNMA	
	Portfolio		Mortgage-Backed Securities						Pass-Through Securities	
	Commitments	Purchases	Out-Standing	Issued	Commitments To Sell	Commitments To Buy	Mortgages Purchased	Mortgages Sold	Applications	Issued
JUL	$1,108	$1,960	$160,636	$4,895	$3,445	$5,328	$3,879	$4,116	$5,514	$6,306
AUG	1,041	1,638	163,253	4,261	4,095	3,480	3,858	3,719	6,517	6,327
SEP	1,439	1,111	167,170	5,622	4,234	6,208	4,192	3,728	5,975	5,684
OCT	**1,740**	**1,488**	**170,395**	**4,772**	**NA**	**NA**	**NA**	**NA**	**5,599**	**5,823**
1987 TOTAL	25,415	20,531	---	63,230	68,210	76,615	76,840	75,018	116,611	96,983
1986 TOTAL	32,987	30,826	---	60,566	107,209	136,179	103,474	102,431	152,911	98,169
10 MONTH AVG.[4] 1988	2,080	1,979	---	4,404	3,280	5,122	3,343	2,929	4,848	4,779
1987	1,940	1,549	---	5,415	6,774	7,204	7,502	7,329	10,833	8,760
1986	2,990	2,549	---	4,944	8,364	11,843	7,860	7,657	12,922	7,643

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES

(Units in Thousands, Seasonally Adjusted Annual Rates)

	BY TYPE OF UNIT						BY REGION							
	HOUSING STARTS			BUILDING PERMITS			HOUSING STARTS				BUILDING PERMITS			
1988	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units	Northeast	Midwest	South	West	Northeast	Midwest	South	West
JUL	1,477	1,119	358	1,420	1,063	357	257	285	562	373	225	255	546	394
AUG	1,461	1,139	322	1,464	1,096	368	218	241	570	432	215	253	562	434
SEP	1,449	1,108	341	1,394	1,049	345	207	249	560	433	192	251	547	404
OCT	**1,554**	**1,219**	**335**	**1,497**	**1,112**	**385**	**202**	**268**	**586**	**498**	**209**	**258**	**550**	**480**
1987 TOTAL	1,621	1,212	409	1,535	1,114	421	269	298	634	420	272	282	575	406
1986 TOTAL	1,805	1,263	542	1,769	1,186	584	294	296	733	483	283	290	687	510
10 MONTH AVG. (SAAR)														
1988	1,481	1,140	341	1,431	1,067	364	249	267	565	401	242	261	533	395
1987	1,655	1,240	415	1,568	1,137	431	278	311	636	430	277	298	583	410
1986	1,828	1,268	560	1,771	1,181	590	301	295	753	480	283	289	703	496

HOME SALES

(Units in Thousands)

	EXISTING HOMES			NEW HOMES		
1988	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate
JUL	3,630	2,500	8.3	703	365	6.4
AUG	3,710	2,520	8.2	718	363	6.2
SEP	3,670	2,420	7.9	708	361	6.4
OCT	**3,630**	**2,200**	**7.3**	**733**	**356**	**5.9**
1987 TOTAL	3,526	---	---	671	---	---
1986 TOTAL	3,565	---	---	750	---	---
10 MONTH AVG. (SAAR)						
1988	3,532	---	---	683	---	---
1987	3,561	---	---	684	---	---
1986	3,487	---	---	748	---	---

VALUE OF NEW PRIVATE CONSTRUCTION PUT IN PLACE

(Units in Billions of 1982 Dollars, Seasonally Adjusted Annual Rates)

1988	Total[5]	1−Unit	2+ Units	Nonresidential
JUL	$279.5	$101.3	$19.3	$77.2
AUG	282.8	102.2	19.1	76.9
SEP	283.0	103.1	19.3	75.9
OCT	**284.1**	**104.6**	**19.0**	**76.1**
1987 TOTAL	283.0	100.7	22.4	78.2
1986 TOTAL	281.8	92.0	28.0	79.8
10 MONTH AVG. (SAAR)				
1988	280.0	102.9	19.3	77.6
1987	281.8	100.0	22.6	77.5
1986	280.6	90.3	28.0	80.4

LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED
By Type of Institution and By Type of Unit

(Dollars in Millions)

1988	1-4 UNITS					5+ UNITS					NONRESIDENTIAL				
	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies
APR	$28,420	$6,702	$14,153	$7,062	$165	$2,744	$270	$1,475	$414	$430	$14,276	$28	$1,619	$10,477	$1,737
MAY	33,300	7,277	16,518	8,899	253	3,253	256	1,636	883	323	16,654	48	1,872	11,795	2,802
JUN	41,765	9,914	20,031	10,938	464	3,844	593	2,167	711	188	16,074	63	2,256	10,551	3,095
JUL	**34,386**	**7,685**	**17,072**	**8,823**	**495**	**3,513**	**837**	**1,582**	**701**	**254**	**14,839**	**128**	**1,844**	**9,640**	**3,063**
1987 TOTAL	449,544	110,093	208,054	124,551	3,209	44,981	2,409	22,492	8,299	3,547	168,652	2,871	25,613	110,490	28,160
1986 TOTAL	455,054	131,628	207,182	108,613	3,814	49,868	7,172	22,769	7,176	3,723	147,374	4,084	27,306	83,929	29,906
7 MONTH AVG. 1988	29,565	7,057	14,329	7,608	231	2,906	380	1,553	566	246	14,702	61	1,836	10,431	2,157
1987	42,001	11,088	18,575	11,747	318	4,221	209	1,823	836	266	12,402	307	2,048	8,575	1,885
1986	32,775	9,816	15,332	7,033	263	3,415	449	1,473	420	306	9,889	247	1,933	5,548	1,991

MORTGAGE INSURANCE

(Units in Thousands, Dollars in Millions)

1988	APPLICATIONS RECEIVED (Units)				LOANS INSURED							
	TOTAL	FHA[8]	VA	PRIVATE	TOTAL		FHA		VA		PRIVATE	
					Units	Amount	Units	Amount	Units	Amount	Units	Amount
JUL	147	75	18	55	130	$9,565	72	$4,383	17	$1,287	41	$3,895
AUG	162	85	22	55	129	9,588	66	4,070	19	1,451	43	4,068
SEP	**141**	**72**	**19**	**50**	**117**	**8,732**	**59**	**3,655**	**20**	**1,505**	**38**	**3,572**
OCT	**135**	**70**	**19**	**46**	**129**	**9,468**	**75**	**4,642**	**18**	**1,389**	**36**	**3,437**
1987 TOTAL	2,340	1,211	408	721	2,282	159,668	1,320	81,881	451	33,312	511	44,475
1986 TOTAL	3,281	1,907	450	923	1,853	127,757	921	56,901	346	24,718	586	46,138
10 MONTH AVG. 1988	151	82	18	51	114	8,315	60	3,654	18	1,307	36	3,354
1987	211	111	37	63	203	14,179	119	7,380	40	2,992	44	3,807
1986	287	170	37	80	149	10,249	72	4,444	28	1,970	49	3,835

NA—Not Available; SAAR—Seasonally Adjusted Annual Rate

[1] Secondary market gross yields. Numbers shown for each month are the average of yields from the first day of the month shown and the first day of the subsequent month.

[2] Effective rate on loans closed.

[3] Securities for 0 to 30 day delivery.

[4] Average covers one month less for FHLMC.

[5] In addition to the categories of private construction shown, the total also includes these categories: residential improvements, railroads, electric light and power, gas, telephone and telegraph, petroleum pipelines, and farm nonresidential.

[6] In addition to the categories shown, the total also includes private pension funds, private MBS conduits, state and local retirement funds, Federal credit agencies, mortgage pools, and state and local investment agencies.

[7] Savings & Loans and Mutual Savings Banks.

[8] FHA applications received includes the Direct Endorsement Program.

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Exclusive Interview
with HUD Secretary
Jack Kemp

CONTENTS

FEBRUARY 1989 VOLUME 49 NUMBER 5

COVER: Technology in real estate finance

Is there room in your offices for a super computer? Whatever your answer, it is being used by a number of major firms on Wall Street and your operations may well be affected by how well they project the future. The tough question is which software has the right innards.

16 **Giant Mortgage Modellers** Each approach is different, and there may be no one that is perfect. Yet, one or all of them may provide crucial guidance to today's mortgage investors. By RICHARD BRUNS

27 **Great Pacific's Productivity Tool** Competition isn't the only reason why mortgage companies are finding computers useful. By WILLIAM G. CUSHING

33 **Bar Codes and Configurations** By borrowing a computer tactic from the supermarket industry, a mortgage company may be able to improve the earnings from the cash register. By WILLIAM SEYMOUR

42 **The New Era** Computer aided underwriting can reduce risks if properly used. By WILLIAM C. MORSCH

Management 48 **Promotion Gifts** They can help or they can hurt depending on what they are and how you use them. By AVRAHAM SHAMA AND JACK K. THOMPSON

Politics 56 **Jack Kemp Takes the Reins at HUD** HUD's new secretary says what he wants to do and how he intends to do it.

Strategic Planning 62 **The Consolidation Trend** Historical forces are converging on the mortgage field. A smaller industry will be the net result. By DALE ANNE REISS AND JOSEPH DUNCAN

Income Property 69 **The New Frontier for Investment Packaging** For investment packaging, commercial real estate may be a bargain, but it needs to be looked at carefully. By CHRISTOPHER LEE

Executive Essay 77 **The Third Dimensional Approach** Sound real estate appraising requires a perspective on various futures. By STEPHEN T. CROSSON

DEPARTMENTS
9 LETTERS
13 BUSINESS ALERT
81 BOOK REVIEW
83 PEOPLE
85 THE SECONDARY MARKET
87 ECONOMIC TRENDS

COVER ILLUSTRATION BY DAVE JONASON

PORTFOLIO

Understanding Provides Perspective

The more things change, the more they stay the same. But that old adage does not seem to apply to today's mortgage industry—where staying with the shopworn status quo can mean being left behind the competition.

Change is evident everywhere in the mortgage banking industry. The industry is undergoing a period marked by major upheaval. No one can safely predict what the future will bring, except that it will be profoundly different.

Technology is one of the driving forces behind the change. It is, at once, both a cause and a solution. Mortgage Company A uses a computer to process loans, and it gets the job done in half the time required by Mortgage Company B. Company B starts to lose business. It looks for the reason and finds it: the computer. So it has to decide whether to automate, and if so, what type of computer system, and to what uses should it be put? Who should be trained? How much will it cost? What will the benefits be? If the company decides not to automate, then the question of survival may become the matter at hand.

In this issue of *Mortgage Banking*, we take a look at how technology is transforming the mortgage finance business—how it is both causing change and supplying solutions to both large and small firms. This issue also takes a very important look at the human side too, or to be more specific, what's on the political horizon. The views of new HUD Secretary Jack Kemp are important to the outlook for the industry, and we share them with our readers in an exclusive interview, conducted prior to his Senate confirmation hearings. After reading this, we think it's clear that HUD, at the very least, will have vigorous leadership in the new administration.

From striving to understand all this change, we hope to get a clearer perspective on what to expect tomorrow.

Janet Reilley Hewitt
Editor

COMING IN MARCH

Legislative Fiat

There can be no doubt now that the nation will have a new housing policy in the near future. Among the forces that will forge this policy, there are strong agreements and disagreements. We'll take a look at what to expect, and how the S&L and deficit problems may influence the outcome.

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VITAL STATISTICS

INTEREST RATES & YIELDS

1- TO 4-FAMILY MORTGAGES

1988	FHA OPINION SURVEY	FHLBB			FNMA		FHLMC	
	FHA New Homes[1]	CONVENTIONAL[2] FRM	ARM	Median Cost of Funds FSLIC Institutions	1-Yr. ARM	FRM Conv.	ARMs	FRMs
AUG	10.70%	10.56%	8.47%	7.21%	9.10%	10.49%	8.01%	10.60%
SEP	10.66	10.64	8.51	7.21	8.99	10.25	8.14	10.48
OCT	10.41	10.69	8.58	7.29	8.86	9.97	8.12	10.30
NOV	10.43	10.54	8.76	NA	9.13	10.22	8.16	10.27
DEC	**NA**	**NA**	**NA**	**NA**	**9.39**	**10.59**	**8.40**	**10.61**

SELECTED SECURITIES

1988	FEDERAL FUNDS RATE	PRIME COMMERCIAL PAPER (3-Month)	U.S. GOVERNMENT 6-Month	1-Year	3-Year	10-Year	A-Rated Utility
SEP	8.19%	8.17%	7.43%	8.09%	8.57%	8.98%	10.26%
OCT	8.30	8.24	7.50	8.11	8.43	8.80	10.11
NOV	8.35	8.66	7.86	8.48	8.72	8.96	10.12
DEC	**8.76**	**9.11**	**8.22**	**8.99**	**9.11**	**9.11**	**10.08**

CURRENT SECONDARY MARKET YIELDS

1988	GNMA[3]	FNMA[3]	FHLMC[3]
SEP	10.11%	10.09%	10.06%
OCT	9.96	9.97	9.95
NOV	9.98	9.91	9.89
DEC	**10.26**	**10.24**	**10.22**

SPREADS

(Basis Points)

GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
113	111	108
116	117	115
102	95	93
115	**113**	**111**

SECONDARY MARKET ACTIVITY

(Dollars in Millions)

	FNMA				FHLMC				GNMA	
	Portfolio		Mortgage-Backed Securities						Pass-Through Securities	
1988	Commitments	Purchases	Out-Standing	Issued	Commitments To Sell	Commitments To Buy	Mortgages Purchased	Mortgages Sold	Applications	Issued
AUG	$1,041	$1,638	$163,253	$4,261	$4,095	$3,480	$3,858	$3,719	$6,517	$6,327
SEP	1,439	1,111	167,170	5,622	4,234	6,208	4,192	3,728	5,975	5,684
OCT	1,740	1,488	170,395	4,772	3,983	4,406	4,037	3,674	5,599	5,823
NOV	**1,289**	**1,596**	**174,278**	**5,405**	**NA**	**NA**	**NA**	**NA**	**6,380**	**3,885**
1987 TOTAL	25,415	20,531	---	63,230	68,210	76,615	76,840	75,018	116,611	96,983
1986 TOTAL	32,987	30,826	---	60,566	107,209	136,179	103,474	102,431	152,911	98,169
11 MONTH AVG.[4] 1988	2,008	1,944	---	4,495	3,350	5,051	3,412	3,003	4,407	4,345
1987	2,027	1,526	---	5,169	6,368	7,272	7,060	6,908	10,270	8,390
1986	2,883	2,590	---	5,007	8,907	12,248	8,231	8,031	12,958	7,822

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES

(Units in Thousands, Seasonally Adjusted Annual Rates)

	BY TYPE OF UNIT						BY REGION							
	HOUSING STARTS			BUILDING PERMITS			HOUSING STARTS				BUILDING PERMITS			
1988	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units	Northeast	Midwest	South	West	Northeast	Midwest	South	West
AUG	1,461	1,139	322	1,464	1,096	368	218	241	570	432	215	253	562	434
SEP	1,467	1,106	361	1,394	1,049	345	208	259	573	427	192	251	547	404
OCT	1,542	1,204	338	1,516	1,110	406	202	266	584	490	218	262	564	472
NOV	**1,563**	**1,215**	**348**	**1,517**	**1,122**	**395**	**228**	**244**	**612**	**479**	**208**	**235**	**368**	**506**
1987 TOTAL	1,621	1,212	409	1,535	1,114	421	269	298	634	420	272	282	575	406
1986 TOTAL	1,805	1,263	542	1,769	1,186	584	294	296	733	483	283	290	687	510
11 MONTH AVG. (SAAR)														
1988	1,490	1,146	344	1,440	1,072	368	247	265	570	407	239	259	537	404
1987	1,656	1,235	421	1,558	1,129	429	277	311	637	430	276	294	580	409
1986	1,810	1,261	549	1,760	1,176	584	298	291	741	480	281	289	695	494

HOME SALES

(Units in Thousands)

	EXISTING HOMES			NEW HOMES		
1988	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate
AUG	3,710	2,520	8.2	714	363	6.3
SEP	3,670	2,420	7.9	698	362	6.5
OCT	3,670	2,925	7.4	729	355	6.0
NOV	**3,710**	**2,630**	**8.5**	**671**	**365**	**6.7**
1987 TOTAL	3,526	---	---	671	---	---
1986 TOTAL	3,565	---	---	750	---	---
11 MONTH AVG. (SAAR)						
1988	3,552	---	---	681	---	---
1987	3,544	---	---	681	---	---
1986	3,521	---	---	742	---	---

VALUE OF NEW PRIVATE CONSTRUCTION PUT IN PLACE

(Units in Billions of 1982 Dollars, Seasonally Adjusted Annual Rates)

1988	Total[5]	1−Unit	2+ Units	Nonresidential
AUG	$283.0	$102.0	$19.1	$77.9
SEP	283.3	103.2	19.3	76.6
OCT	285.1	104.8	19.1	77.5
NOV	**285.4**	**107.2**	**18.7**	**76.9**
1987 TOTAL	283.0	100.7	22.4	78.2
1986 TOTAL	281.8	92.0	28.0	79.8
11 MONTH AVG. (SAAR)				
1988	280.6	103.3	19.3	77.7
1987	282.4	100.3	22.5	77.9
1986	281.0	90.9	28.0	80.2

LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED
By Type of Institution and By Type of Unit
(Dollars in Millions)

	1-4 UNITS					5+ UNITS					NONRESIDENTIAL				
1988	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies
MAY	$33,300	$7,277	$16,518	$8,899	$253	$3,253	$256	$1,636	$883	$323	$16,654	$48	$1,872	$11,795	$2,802
JUN	41,765	9,914	20,031	10,938	464	3,844	593	2,167	711	188	16,074	63	2,256	10,551	3,095
JUL	34,284	7,685	17,072	8,823	393	3,631	837	1,582	701	372	13,449	128	1,844	9,640	1,673
AUG	**38,515**	**9,057**	**19,923**	**8,820**	**336**	**3,368**	**278**	**1,901**	**605**	**394**	**14,909**	**156**	**2,115**	**10,250**	**2,244**
1987 TOTAL	449,544	110,093	208,054	124,551	3,209	44,981	2,409	22,492	8,299	3,547	168,652	2,871	25,613	110,490	28,160
1986 TOTAL	455,054	131,628	207,182	108,613	3,814	49,868	7,172	22,769	7,176	3,723	147,374	4,084	27,306	83,929	29,906
8 MONTH AVG.															
1988	30,671	7,307	15,028	7,759	231	2,979	367	1,600	571	279	14,554	73	1,871	10,409	1,994
1987	41,046	10,522	18,399	11,540	308	4,066	193	1,862	796	262	12,876	284	2,006	8,527	1,968
1986	34,538	10,270	13,685	7,599	285	3,540	500	1,536	440	306	10,455	298	2,036	5,950	1,994

MORTGAGE INSURANCE
(Units in Thousands, Dollars in Millions)

	APPLICATIONS RECEIVED (Units)				LOANS INSURED							
1988	TOTAL	FHA[8]	VA	PRIVATE	TOTAL		FHA		VA		PRIVATE	
					Units	Amount	Units	Amount	Units	Amount	Units	Amount
AUG	162	85	22	55	129	$9,588	66	$4,070	19	$1,451	43	$4,068
SEP	141	72	19	50	117	8,732	59	3,655	20	1,505	38	3,572
OCT	**135**	**70**	**19**	**46**	**129**	**9,468**	**75**	**4,642**	**18**	**1,389**	**36**	**3,437**
NOV	**126**	**69**	**17**	**40**	**92**	**7,006**	**41**	**2,535**	**18**	**1,334**	**33**	**3,137**
1987 TOTAL	2,340	1,211	408	721	2,282	159,668	1,320	81,881	451	33,312	511	44,475
1986 TOTAL	3,281	1,907	450	923	1,853	127,757	921	56,901	346	24,718	586	46,138
11 MONTH AVG.												
1988	148	81	17	50	112	8,196	58	3,552	18	1,309	36	3,335
1987	204	106	36	62	196	13,733	114	7,081	39	3,891	43	3,761
1986	278	163	37	78	153	10,495	76	4,670	28	1,996	49	3,829

NA—Not Available; SAAR—Seasonally Adjusted Annual Rate

[1] Secondary market gross yields. Numbers shown for each month are the average of yields from the first day of the month shown and the first day of the subsequent month.

[2] Effective rate on loans closed.

[3] Securities for 0 to 30 day delivery.

[4] Average covers one month less for FHLMC.

[5] In addition to the categories of private construction shown, the total also includes these categories: residential improvements, railroads, electric light and power, gas, telephone and telegraph, petroleum pipelines, and farm nonresidential.

[6] In addition to the categories shown, the total also includes private pension funds, private MBS conduits, state and local retirement funds, Federal credit agencies, mortgage pools, and state and local investment agencies.

[7] Savings & Loans and Mutual Savings Banks.

[8] FHA applications received includes the Direct Endorsement Program.

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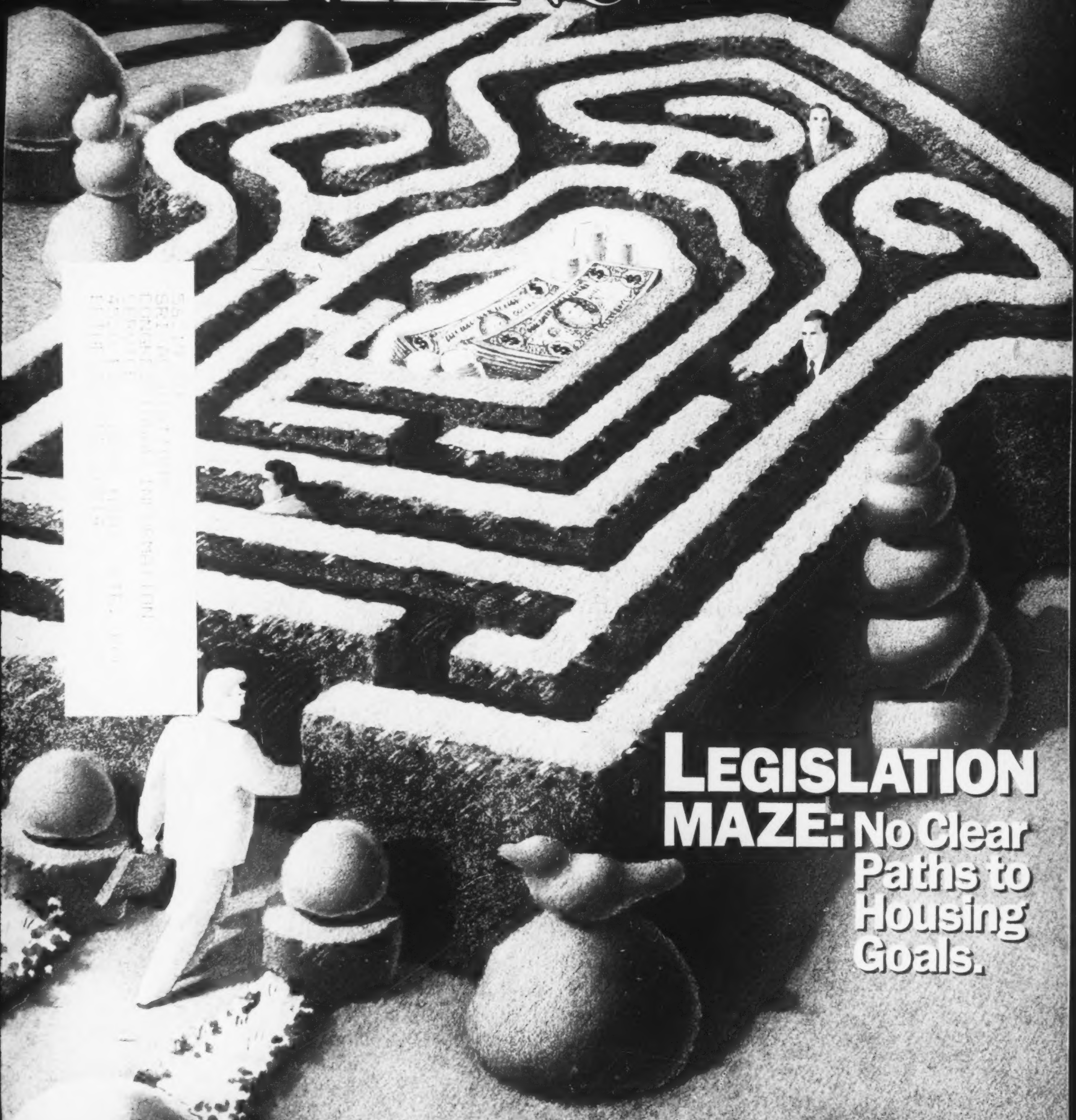
MORTGAGE BANKING

MARCH 1989



LEGISLATION MAZE: No Clear Paths to Housing Goals.

CONTENTS

MARCH 1989 VOLUME 49 NUMBER 6

COVER: The Legislative Maze

In brief terms, the future of housing in America will be highly dependent upon affordability. Will the downward curve that has continued for the past eight years be turned around? How that question is answered will be highly dependent upon the housing policies set by Congress and the executive branch. There are many excellent solutions in the offing, from more flexible FHA terms to tax reform on low- and moderate-income housing. Yet, these solutions face formidable obstacles before they can become reality

14 Legislative Outlook *The 101st session of Congress got off to a positive housing start. But budget constraints and opposing views may hold up any quick action.* By JOSEPH C. DAWSON

22 Congressional Insight *The new chairman of the House Banking Committee, Congressman Henry B. Gonzalez and Congressman John J. LaFalce express their thoughts about housing.*

28 HUD's Jack Kemp Moves In *HUD Secretary Jack Kemp's first days in office began smoothly with a clear set of priorities.*

38 The S&L Bailout Plan *President George Bush's S&L recommendations are seen by industry experts as offering both opportunity and problems.* By H. BYERS KALTENHEUSER, JR.

Management **47 Secrets of Successful Loan Officers** *Twelve top loan originators share their experiences in making it to the top.* By HOWARD SCHNEIDER

Servicing **59 Evaluating Servicing Performance** *Peat Marwick's survey of 18 lenders explains how to identify strengths and weaknesses in the servicing department.* By GREGORY A. BALDRIDGE

Survey **63 The Mind of the Realtor** *The thinking patterns of Realtors are not always examined properly by lenders.* By JOHN C. CAMPBELL AND DONALD W. LIEF

Servicing **69 Economies of Scale and Profitability** *Size is not the only factor in determining the bottom line.* By VICTOR CHOLEWICKI

Regulatory **79 HUD's New Coinsurance Program** *Nursing homes offer great potential for mortgagors, but there are pitfalls in HUD's new plan to spur the market.* By W. THOMAS BOOHER AND HENRY J. BROTHERS

Mergers & Acquisitions **85 The Perils of Acquisition** *The service bureau conversion department's involvement may make or break a transaction.* By THOMAS JARRETT

Strategy **89 The New Economics of Mortgaging** *New rules set by industry leaders will determine how individual firms should compete.* By JOHN P. MARA

DEPARTMENTS

9 LETTERS
11 BUSINESS ALERT
96 PEOPLE
99 THE SECONDARY MARKET
101 ECONOMIC TRENDS
106 INDEX TO ADVERTISERS

COVER ILLUSTRATION BY ANNIE LUNSFORD

PORTFOLIO

Legislative Winds of Change

The 101st session of Congress had hardly begun before a number of truths became self-evident. If there were a State of the Union address covering only housing policy, it would spell out these emerging truths as follows.

A sincere, bi-partisan desire now exists for solving housing problems.

Housing policy makers on Capitol Hill and in the executive branch recognize how critical these problems are and what they portend for America.

Finally, vigorous political leadership is in place to attack the issues—HUD Secretary Jack Kemp—the Senate's Alan Cranston and Al D'Amato—the House's Henry Gonzalez. Powerful. Creative. Goal-driven. High-energy levels. These are descriptive adjectives that apply to them all.

But our cover story makes clear, this may not be enough to ensure passage of a comprehensive, effective legislative housing package any time soon. This issue explores the policy obstacles, as well as the opportunities. We take a look at the leaders whose decisions will count. And we also examine how President Bush's S&L bailout plan may affect mortgage bankers.

On other matters, the economics of mortgage finance are changing rapidly and dramatically. This generic theme is examined in articles on the economies of scale, the new economics of mortgaging, the perils of loan acquisition and servicing evaluation. We also take a good look at the mind of a Realtor, and explore the secrets of successful loan officers.

Janet Reilley Hewitt

Janet Reilley Hewitt
Editor

COMING IN APRIL

The Secondary Mortgage Market

To continue a good spring start, our upcoming issue will include a number of useful articles on the secondary market, from evaluating your secondary market results to potential legal pitfalls when making secondary market transactions. We also look at innovative approaches to affordable rental housing, and how a mortgage company of the future might prosper.

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VOLUME 49 NUMBER 6

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THE S&L BAILOUT PLAN

Most mortgage bankers welcome President Bush's S&L proposal. If enacted by Congress, it could have a positive impact on private lenders.

President George Bush's S&L bailout plan, if passed by Congress, could prove to be a welcome relief for private mortgage banks, but not without some costs to the banks and to their customers. Overall, mortgage bankers contacted said the plan, given the costs, complexity and seriousness of the problems, was a reasonable one. And they are pleased the new President acted on the problems so swiftly.

Breifly, the President's proposal would:

- Provide for a government takeover of 350 troubled thrifts;
- Allow a takeover by the Treasury Department of the Federal Home Loan Bank Board, that regulates the nation's 3,100 S&Ls. The Federal Deposit Insurance Corporation would take administrative control of the Federal Savings and Loan Corporation, the thrift insurance fund. The FDIC would manage the S&Ls brought into receivership.
- Establish a new government agency to sell $50 billion of long-term bonds to cover the cost of the bailouts. S&L's would be responsible for the principal, and a portion of the $5 billion in interest payments would be picked up by the government. Banks and thrifts would pay higher premiums for federal insurance, but most of these costs would be passed on to depositors.

FDIC toughness

The rationale for the proposal is that FDIC, which insures deposits made at commercial banks, is a tough regulator and more experienced at handling bank failures than the FHLBB and the FSLIC. With 4,000 employees in the liquidation division, FDIC has been closing down from 100 to 200 banks a year. FHLBB and FSLIC, on the other hand, are perceived as not having the capabilities to deal with the present crisis.

James Pygman, senior vice president for Real Estate Research Corporation, Chicago, said he welcomed the President's proposal. "What you will see after all this is through is a more mature S&L industry, without so much risk-taking and predatory practices," he said. Pygman said the S&L crisis was similar in some respects to the real estate investment trust scandals of the mid-1970s that took more than five years to resolve and in some cases is still going on. "One problem is you have many good S&Ls out there, and they have all been painted with the same tar brush. The good ones will be much better off when this is all over," he said. On the other hand, Pygman said the proposal would mean higher costs for everyone involved in home lending and borrowing.

Somewhat the same assessment was given by James W. Wooten, chairman of Lomas Mortgage USA, Dallas. Wooten said he was pleased the President stepped up to the problem as quickly as he did, and that the proposal represented a reasonable solution to a very complex problem. When and if the plan is enacted, Wooten said, many S&Ls "will be initially less aggressive in their marketing mortgage efforts because they will be engulfed in straightening out their problems. They'll be looking at what they bought and what it means." Wooten says he expects everyone will be a "little tougher on all fees to customers."

Wooten said the increased costs to S&Ls, and a limit on their operations, could affect their competitiveness. "They will have to ask themselves," he said, "how can we be competitive at increased costs?"

Albert C. Kocourek, president of First Advantage Mortgage Corporation, Columbia, Maryland, welcomed the plan. "I'm very pleased that a concrete proposal is on the table that looks like it makes sense. It may not please everyone, but it will go a long way to solving the problem. Some of

ILLUSTRATION BY ERIC WESTBROOK

H. Byers Kaltenheuser, Jr.

the convoluted package is obviously political, with its off-budget disguise, but that's fine if that's what it takes to sell it. I assume that the government will stop masking problems by getting rid of regular accounting procedures and basing audits on generally accepted accounting procedures that would no longer make S&Ls look better than they are. Mortgage bankers will clearly benefit if S&L abuses are addressed and the industry is stopped from pricing products as if it had nothing to lose, which it didn't as long as it could count on a taxpayer bailout. With S&Ls as subsidized players, the entire housing system was weakening as the financial structures of mortgage institutions took a beating. Given the S&Ls large share of the market, they pulled everyone down.

Consolidation trend

Kocourek was one of a number of mortgage banking executives who said that there wasn't any more need for a separate S&L industry. "Banks can do it all," he said, "and their abuses are nothing like the widespread corruption in the S&L industry. The solid, excellently run S&Ls are already in transition to becoming well-run banks with a retail customer base while keeping mortgages as their primary investment. A great deal of consolidation will result, and the biggest problem will be obtaining the required capital. The good news is that the new risk-based capital rules favor mortgages and mortgage securities."

Possible congressional delays concerned C. William Blomquist, president of Perpetual Mortgage in McLean, Virginia. "My concern is the loss of confidence major delays might convey, that they result in a major runoff of deposits to stocks and money market funds, that could drive up interest rates. I don't see a major effect on the consumer. In the short run, the loss will center on dividends and profits. Hopefully, this will be behind us in three years."

In nearby Fairfax, Virginia, Rich Becker, executive vice president of James Madison Mortgage, says he hopes that sensibility in pricing will evolve. "Now," he said, "there is no way the secondary markets can figure out the S&L teaser rates." Becker hopes the controls that will be imposed will eliminate specious gambling on ARM rates, where an S&L profits if rates are favorable, and shrugs the problems off to someone else if they are not.

Many experts believe a risk-free mentality is the heart of S&L problems. Bert Ely, a financial institutions consultant in Alexandria, Virginia, maintains that thrifts are harmed by the overcapacity that exists because of the perpetuation of insolvent thrifts. "We have too many organizations, too many offices and too big a deposit base out there. Had the thrifts been a normal industry, this overcapacity would have been liquidated some time ago."

Ely believes public policy failures have created a greenhouse for fraud, greed and mismanagement. He regards such activity as systematic, the root cause of an inherently flawed and actuarially unsound federal deposit insurance mechanism. "The drunk drivers of the banking and thrift worlds pay the same price for the deposit insurance as do their sober brethren," he says. Ely notes that thrifts now originate only half of home mortgages, with banks, mortgage bankers and credit unions doing the rest, without special government inducements.

Global considerations

Another expert, Gregg Edwards, director of the Academy for Advanced and Strategic Studies, a Washington-D.C. think tank, believes that any S&L solution consider global financial prob-

What Will Congress Do? When Will They Do it?

Congress has a number of reservations about President Bush's S&L proposals and a number of compromises are likely before a bill is enacted. That's the inital reaction from Capitol Hill.

Congressman Charles Schumer (D-NY), recently appointed chairman of a special House Budget Committee task force on urgent financial problems, predicted that the basic structure will prevail with some modifications added by Congress.

Schumer said he has reservations about the bond portion of the plan, that it will ulimately cost taxpayers a billion dollars more per year each of the next 30 years than if the Treasury simply handled it. "That's a pretty stiff price for 'reading my lips' and I hope Congress straigtens that out," Schumer said.

Congressman Henry Gonzalez (D-TX), new chairman of the House Banking Committee, says he is witholding judgment on the President's proposal until it has had a full hearing. Gonzalez believes the S&L industry should solve its own problem to the maximum extent possible. He believes Congress should protect small depositors from having major costs passed on to them in the form of fees and fears that the proposed deposit premiums could generate hidden costs that dwarf Treasury's earlier plan for a user fee. He also is concerned about the problem created by state-chartered S&Ls that have more leeway than those chartered by the federal government. He believes federal insurance should be witheld from any state chartered institution that does not abide by high federal standards.

Gonzalez's concern over state-chartered institutions is shared by Senator Donald W. Riegle (D-MI), chairman of the Senate Banking Committee. "The proposal must clearly restrict the kind of risky activities in the future that helped create the problem in the past. For example, many states permit state-chartered thrift institutions to exercise powers much broader than those of federally chartered S&Ls. If a savings and loan is going to be federally insured, then we clearly limit the risks to which it is exposed. I believe it's time for Congress—and not just the regulators—to make the basic decisions in this area," Riegle said. Otherwise, he added, the President's plan was "sensible and constructive."

The S&L proposals are clearly on a fast congressional track. Some optimists hope for passage by June, but others do not expect a comprehensive package to be passed until the fall.

lems that are accelerating at a rapid rate. "If an S&L is just local folks looking at real estate while ignoring a globally sophisticated financial system, you immediately have a culture gap," he says. He foresees increasing opportunities created for mortgage bankers who provide S&Ls with the ability to work out deals between global financial markets and local needs.

"There is a good potential for savvy mortgage bankers to pick up S&Ls that have not just the best loan portfolio but the best people portfolios in terms of developing sophistication and contacts. There will always be a niche in the financial industry that attracts people who seek a local connection. Traditionally the link has been land. Now the challenge is to provide a wider service to the local economy while dealing with global flows. If S&Ls remain local populist institutions in the banking community, it will not be a simple distinction of real estate. Who is going to be the Wal-Mart of banking?" Edwards asks.

CHART 1

S&Ls In Trouble

Thrifts with less than 1.5% capital	150
Assets	$137 billion
Tangible net worth	- $1.3 billion
1988 third quarter loss	$205 million
Thrifts with capital of $1.5% to 3%	254
Assets	$152 billion
Tangible net worth	$1.1 billion
1988 third quarter net loss	$34 million

Source: Federal Home Loan Bank Board, as of Sept. 30, 1988.

Graig Simmons, a thrift specialist for the General Accounting Office, said, "If we get an interest rate spike, a recession, or some other adverse development, these thrifts are very vulnerable."

However, Wade Nowlin, chief executive officer for the Nowlin Mortgage Company in Fort Worth, doesn't see any less competitiveness in the future resulting from the implementation of the President's proposal. "They have got all the bad ones already," he says, and he doesn't think the remaining S&Ls will lower their competitive efforts. **MB**

H. Byers Kaltenheuser is a Washington, D.C.-based lawyer who specializes as a writer on housing and finance.

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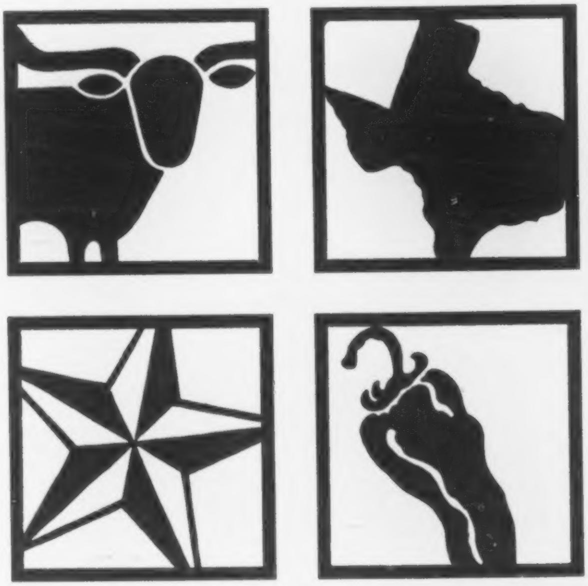

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Peat Marwick's in-depth survey of mortgage servicing produces a few surprises as well as guidance to spotting what's right and wrong.

EVALUATING SERVICING PERFORMANCES

Gregory A. Baldridge

During June 1988, KPMG Peat Marwick completed its second annual mortgage servicing performance study (MSPS) for the largest mortgage servicers in the country. The study involved data from 1987 and documented costs per loan, unit costs, productivity measures, reporting standards and key operating variables for 17 servicing functions. Using that information, participants gained a greater understanding of their relative strengths and weaknesses and have been able to enhance overall operating performance. With servicing executives under significant competitive pressure to generate additional profits, this information has helped them develop new insights and communicate new procedures or trends in the business.

The foundation of the study was the impressive group of companies involved in the effort. Of the 18 participants, seven were among the top ten residential servicers in the country, and all of the companies serviced at least 80,000 loans. The participant group represented key industry leaders from a cross-section of the country. Peat Marwick's role was to provide a framework for the data gathering and analyses and conduct a seminar for the senior executives of the participating firms. At the seminar, the executives shared their experiences and discussed the strategic and tactical implications of the results. Some of those insights are discussed throughout this article.

Overall cost results

Total servicing costs ranged from $80 to $245 per loan (average of $129) and included core servicing functions, loan losses, various interest expenses and allocated overhead. Chart 1 outlines the relative distribution of the total costs. Note that collateral losses from bad loans (i.e. loan losses) represented 20 percent of the total servicing costs. Loan losses did not include collections or foreclosure processing costs but they did include principal losses from loans sold with recourse, VA no-bids and non-reimbursable outside service expenses.

Core servicing costs ranged from $60 to $125 (average $82) and excluded loan losses, interest expenses and allocated overhead. The customer service and collections and foreclosures departments accounted for 50 percent of core costs.

Most of the analytical work was conducted for each of the 17 servicing functions (e.g. collections and foreclosures, data processing, etc.). However, there were some general observations which applied across all functions.

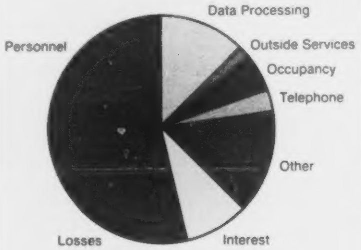
- The underlying loans in the portfolios were distributed as follows: FHA (27 percent), VA (20 percent), conventional fixed (37 percent), conventional adjustables (14 percent) and other (2 percent). Ginnie Mae, Fannie Mae and Freddie Mac accounted for 60 percent of the loans.
- For all participants, the average core servicing costs increased only 2 percent from $80 to $82 per loan between 1986 to 1987. However, for individual participants, core costs changed significantly ranging from an 11 percent decrease to a 21 percent increase. This indicates that the servicing cost equation can change more rapidly than most people expect.
- Loans serviced FTE turned out to be a reasonably good macro predictor of core servicing costs. For the participants in the study, loans serviced per FTE ranged from 450 to 900.
- There was no apparent relationship between core costs and portfolio size indicating that economies of scale probably are limited for these large servicers.
- There was no obvious relationship between total costs and the amount of government loans in the servicing

portfolio. This result runs contrary to conventional wisdom that suggests that government loan servicing is more expensive due to issues such as VA no-bids and regulatory compliance.

CHART 1

Total Cost Components

Bad loan losses (i.e. collateral losses) represent over 20% of total servicing costs.



- There was no general evidence that higher staff compensation contributed to higher productivity.

Collections and foreclosures

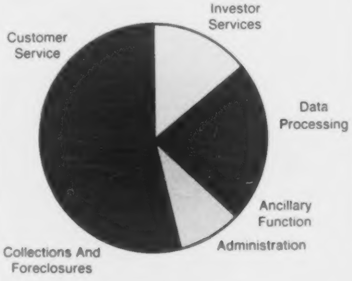
The collections and foreclosures areas contributed an average of $51 to the toal costs per loan (processing costs were $20 per loan and loan losses were $31 per loan). This portion of the study examined cost, productivity and effectiveness measures for the collections, foreclosures, bankruptcies and REO departments. Overall, these functions, including loan losses, accounted for about 40 percent of the total servicing costs. Loan losses, in particular, dominated this portion of the analysis with costs varying widely from $20 to almost $120 per loan. It is clear that many of these servicers have experienced the travails associated with foreclosures in several high-risk states. At the same time, however, they are actively enhancing their management information to provide better insights into the costs and effectiveness of collections and foreclosure efforts. Other observations about this area are profiled next.

- In the collections processing arena, four of the most productive participants (defined as delinquencies process per FTE) used an award or bonus system for their collections staff. Cash bonuses or days off seemed to be the most successful.
- The best standard for effectiveness appeared to be the ratio of 60-day delinquents to 30-day delinquents. Interestingly, there was no apparent relationship between unit processing costs and effectiveness. Stated differently, the companies that spent more per collection effort did not receive materially better collections performance. To counter this result and improve effectiveness, many companies have focused their collections efforts on the customer who is 15 to 30 days delinquent. The intent is to intervene at the earliest possible stage in the delinquency process.
- Automated tracking systems in the foreclosures area were used by four of the five most productive companies (defined as foreclosures completed per FTE). This resulted in more timely information that improved overall quality control and enhanced the claims filing process.

CHART 2

Core Cost By Function

The customer services and collections and foreclosures departments account for more than 50% of total core costs, that exclude bad loan losses, interest expenses and allocated overhead.



- Reinstatement rates varied from less than 10 percent to more than 60 percent of loans entering foreclosure. Most of the high reinstatement rates were from portfolios with loan concentrations in California where property values provide an incentive for the borrower to avoid the foreclosure process. High reinstatements favorably influence foreclosure productivity and should be part of the management information system.

Customer service

The customer service functions contributed an average of $37 to the total servicing costs per loan. These functions encompassed the assumptions, payoffs, taxes, insurance, escrow analysis and customer inquiry units. The customer inquiry function received attention during the participants' seminar. Productivity for this function ranged from 200 inquiries to 1,900 inquiries per FTE per month which indicates that there was significant variability in how this department was structured. Most participants are broadening their definitions of adequate customer service by setting standards for such things as average call length, average wait time, abandonment rate, blockage rate, recalls, transfers, etc. One of the first steps in improving customer service is to define the purpose of an inquiry. Chart 3 highlights the top five reasons for a customer inquiry. With this information, a firm could staff and train the department more effectively.

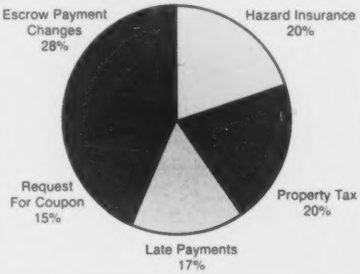
There are some observations about the various customer services functions.

- Tax penalties and interest losses on pool payoffs accounted for 10 percent of customer service costs.
- There was poor information to distinguish between principal and interest advances on delinquent loans and interest losses on pool payoffs. This information is useful in determining servicing costs by product which is critical for overall product profitability analyses.

CHART 3

Top Five Customer Inquiry Reasons

The volume of customer inquiries can be reduced by pro-actively addressing questions regarding changes in escrow payments. Forty-four percent of study participants indicated that escrow payment changes were the number one reason for calling, while all of them said it was among the top five reasons.



Data processing (DP) costs contributed an average of $17 to total servicing costs per loan, but they varied from $7 to $44 per loan among the participants. The key question was whether additional DP costs improved servicing productivity or quality of service. Based on a series of analyses, there was no apparent beneficial relationship between increased data processing expenditures and overall servicing costs. In addition, there was no apparent beneficial relationship between increased data processing costs and general servicing productivity. We also contrasted DP cost per loan with the software systems used. In general, participants that accepted the inherent restrictions of software packages and service bureaus had more consistent and usually lower DP costs. Overall, most participants agreed that DP costs require strict control and thoughtful justification because the incremental expenses do not seem to generate adequate benefits.

The following comments represent findings from the other areas covered in the survey.

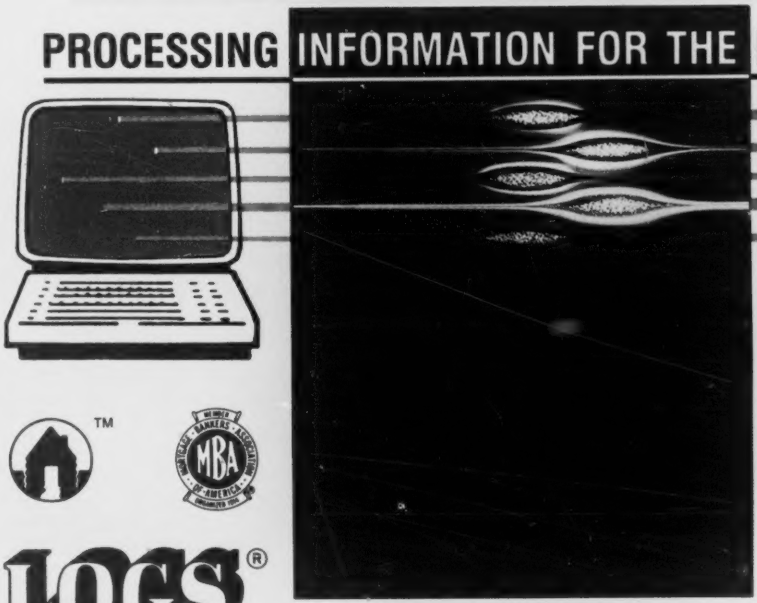
- *Investor services and cashiering*—It appears that computer software design has more impact on investor reporting productivity than management experience, staff turnover or staff compensation.
- *Investor services and cashiering*—Investor accounting costs can be dramatically affected by bank fees for custodial accounts. Most participants do not have adequate data to assess the cost of bank fees relative to the value of compensating balances.
- *Ancillary functions*—Record retention expenses were more consistent and generally lower if off-site storage was used to some extent.
- *Ancillary functions*—The use of film/fiche as a storage medium seems to make costs more difficult to control. However, reductions in staff and storage spaces as well as improved response to file requests should be part of the equation before conclusions are reached.

Major messages

Treat the servicing department as a profit center not a cost center. That is one major message from MSPS that is transferable to financial institutions and mortgage companies with small to medium servicing portfolios. Within the profit center context, there are serveral ideas and perceptions that are important.

- Detailed cost and performance information represents opportunities for improvement. It does not represent a threat to job security.
- The servicing executive should be involved in product development and other production-related decisions to contribute information about product profitability and the impact on servicing costs.
- The servicing department has repeated contact with many customers through such areas as customer inquiries, billing statements, escrow services, etc. That contact presents a company image that can provide benefits to an aggressive institution.
- Finally, the servicing executive must deal with a myriad of operations, finance and industry-related issues. The executive should have a framework to detect early warnings of impending problems by closely monitoring trends. That framework is extremely valuable because production could be re-focused or the servicing portfolio could be restructured to avoid excessive financial exposure. **MB**

Gregory Baldridge is a senior manager in KPMG Peat Marwick's San Francisco office. He is one of the firm's leading consultants to the mortgage banking industry.



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Individual competence ranks high in a Realtor's selection of a lender.

The Mind of the REALTOR

Ongoing market-driven relationships between lenders and real estate agents are experiencing stresses that are not yet fully defined. Lenders have emphasized service as an important strategy for coping with some of these sweeping changes. Have traditional attitudes changed? What factors contribute most heavily to the relationship?

A recent survey in four active housing markets, from Boston to Orlando, clearly shows that a remarkably strong consensus exists on the relative importance of many aspects of lenders' service. Behind this consensus, however, attitudinal differences toward individual lenders within each market display a pattern that is seldom examined by lending institutions, including mortgage bankers.

The telephone survey—conducted in November and December 1988 among 1,200 Realtors—was designed to provide lenders in each market with in-depth comparative data on how they and their competitors are perceived by licensed real estate brokers. The survey also explored important factors that influence the effectiveness of loan officers.

Eight in ten Realtors noted the importance of loan officers and recommended that they would probably follow a loan officer to another institution if they were well satisfied with his or her performance. This view is equally strong in each area surveyed: Boston, Philadelphia, Washington, and Orlando (See Table 1). It is also substantially similar regardless of the real estate company's size.

Realtors, when deciding what is most important about a lender, confirm many conclusions of the 1986 Mortgage Bankers Association national survey of 426 active Realtors. But the relative "extreme" importance of the highest factor—speed of processing—is seven times greater than that of the lowest—affiliation with a national company. This pattern is consistent within all markets and among most Realtors. Interestingly, the smallest firms generally rank all factors higher than medium-sized firms, and in Philadelphia the lender's reputation is as important as the rates.

The actual loan rate charged is equal in importance to a factor not explored in the earlier survey: how well the lender's underwriting guidelines accommodate the majority of customers. The percentage of Realtors who regard each factor as "extremely important" is shown in Table 2.

The core of the survey examined

John C. Campbell and Donald W. Lief

ILLUSTRATION BY LINA CHESAK

Realtors' recent experiences with individual lending institutions. When asked to grade (A through F) a lender with whom they had worked during the previous six months, response rates were extremely high—often above 90 percent. Each lender was graded on most of the factors already determined to be important.

At the same time, however, an extremely high number of Realtors could or would not name individual lenders according to the same criteria (e.g., responsiveness, speed of processing, loan rates).

Lending officer qualities

Realtors also graded lending officers of the same institutions with which they had recent experience. The message is that, above all, a successful loan officer must be knowledgeable. More than 80 percent of respondents in Orlando, Washington and Boston called this characteristic "extremely important," substantially overshadowing other qualities. Friendliness of the loan officer is the least "extremely" important, at about 40 percent in the four markets. These factors are compared in Table 3.

Again, behind the overwhelming four-market consensus, distinctions can be made. In Orlando, both the smallest and largest firms are most positive about these lending officer qualities; in Philadelphia, the larger firms think far more highly of them.

Real estate agents continue to make frequent referrals of customers to lenders but there may be warning signals of a possible declining trend in referrals. About 60 percent of Realtors recommend a source for at least three-fourths of their customers. The practice ranges from 53 percent in Boston to 64 percent in Washington. This compares with the 90 percent rate of at least one recommendation determined in the 1986 MBA survey.

The 1986 survey reported that 81 percent of the Realtors believed that their recommendations were always followed by the homebuyer. In contrast, the four-market 1988 survey asked about the success rate of these referrals. The results vary widely: from Boston's 45 percent to Washington's 66 percent, among those whose recommendations led to financing at least 75 percent of the time.

Whether this represents a trend was not the subject of the study. The data may also reflect increased efforts by many lenders to reach borrowers directly instead of through intermediaries.

Within markets, the survey reveals distinct patterns. In Boston, the smallest firms—fewer than 25 residential sales in six months—are more likely to recommend financing sources, possibly because first-time homebuyers

TABLE 1

Realtor-Lending Officer Links Are Strong

(Percent of Realtors who would continue referrals)

Orlando	79%
Philadelphia	76%
Washington	80%
Boston	78%

TABLE 2

Factors Influencing Realtor-Lender Relationships

(Percent of "extremely important" responses)

	Orlando	Boston	Washington	Philadelphia
Speed of Processing	68%	70%	66%	75%
Guidelines Meet Needs Of Customers	61	62	63	59
Rates Charged	58	68	60	55
Points	57	53	61	52
Variety Of Loans	53	55	50	37
Reputation	49	50	48	53
Convenient Hours	47	37	40	40
Location	18	18	14	12
National Affiliation	10	9	8	8

TABLE 3

Importance of Lending Officer Qualities

(Percent of "extremely important" responses)

	Orlando	Boston	Washington	Philadelpia
Knowledgeable About Loan Types	85%	86%	82%	65%
Accessibility	68	72	72	67
Eagerness To Have Application Approved	57	62	58	59
Creativity	55	66	59	50
Detail-oriented	51	59	58	59
Friendliness	44	44	40	42

TABLE 4

Weak Identification of Lending Firms

(Percentage of responses for most-frequently named institution)

	Orlando	Boston	Washington	Philadelphia	Percent Non-Response
Responsive	7.6%	13.9%	16%	14.3%	46%
Error-prone	3.3	1.9	2.7	5.2	69
Aggressive	6.2	6.8	10.4	9.1	50
Lengthy Application Process	2.8	4.2	2.7	4.8	68
Knowledgeable	5.7	7.4	10.7	7.8	50
Inconvenient To Deal With	3.3	3.9	1.9	3.0	73
Excellent Reputation	8.1	12.9	13.9	9.6	48
Competitive Rates	3.3	5.2	7.7	7.4	54
Reliability of Loan Officers	5.2	8.7	10.9	8.7	49
Slow Processing Time	3.8	4.9	4.8	5.7	67

are a comparatively larger share of their business. Their referrals, however, result far more often in conventional loans rather than FHA or VA-insured mortgages. Less than 2 percent of all Boston Realtors report FHA-insured loans as being more than half their business.

The survey's primary purpose was to investigate Realtors' perceptions of and experiences with leading lenders in each market. Each sponsor received detailed comparative information and each provided private questions that were asked as part of the survey interview. Responses—including open-ended—were correlated and analyzed in relation to the public questions.

Many private questions dealt with even more detailed comparisons of satisfaction with competing lenders. A substantial number of private questions assessed Realtor attitudes toward programs providing fees for referrals.

In addition, the survey asked Realtors about current and prospective business activity in their markets. Their answers, on the whole, present a highly optimistic view of the housing industry in upcoming months.

As additional surveys are conducted within other markets, a fuller picture of the enduring Realtor-lender relationship will emerge. **MB**

John C. Campbell is president of Campbell Communications, Inc., Bethesda, Maryland, a public relations and marketing company with corporate and association clients in the real estate finance industry. Donald W. Lief, APR, a senior associate of Campbell Communications, Inc., heads its Relatek Information Group specializing in relationship market research, including surveys that measure significant business-to-business relationships.

Lenders' Name Recognition is Flawed Among Realtors

Responses to the survey's questions were typically in the 80 to 95 percent range. A conspicuous exception came when Realtors were asked to name lending institutions that came to mind in relation to a variety of words. The response rate plunged: Some questions drew as few as 28 percent. Despite this, the statistical pattern of non-responsiveness was almost totally consistent among different questions and markets.

Why would Realtors not identify lending institutions in terms such as "responsive," "knowledgeable," "inconvenient to deal with" or "slow processing time?" One obvious conclusion is that lenders have done a poor job of positioning themselves in their relationships with Realtors.

There is some supporting evidence for this interpretation. Although very few lenders were identified by even 10 percent of the real estate agents, each housing market found a single lender to be clearly most visible among Realtors.

In Orlando and Boston, one lender came in first in six of the ten questions. In Washington, two lenders were mentioned most in four of the factors. In Philadelphia, Realtors gave the top spot in all 10 to the same lender. It is intriguing that the questions included positive and negative characteristics.

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VITAL STATISTICS

INTEREST RATES & YIELDS

1- TO 4-FAMILY MORTGAGES

1988	FHA OPINION SURVEY	FHLBB			FNMA		FHLMC	
	FHA New Homes[1]	CONVENTIONAL[2] FRM	CONVENTIONAL[2] ARM	Median Cost of Funds FSLIC Institutions	1-Yr. ARM	FRM Conv.	ARMs	FRMs
SEP	10.66%	10.64%	8.51%	7.21%	8.99%	10.25%	8.14%	10.48%
OCT	10.41	10.69	8.58	7.29	8.86	9.97	8.12	10.30
NOV	10.43	10.54	8.76	7.35	9.13	10.22	8.16	10.27
DEC	10.72	10.53	8.78	NA	9.39	10.59	8.40	10.61
JAN	**NA**	**10.62**	**8.84**	**NA**	**9.46**	**10.59**	**8.55**	**10.73**

SELECTED SECURITIES

1988	FEDERAL FUNDS RATE	PRIME COMMERCIAL PAPER (3-Month)	U.S. GOVERNMENT 6-Month	U.S. GOVERNMENT 1-Year	U.S. GOVERNMENT 3-Year	U.S. GOVERNMENT 10-Year	A-Rated Utility
OCT	8.30%	8.24%	7.50%	8.11%	8.43%	8.80%	10.11%
NOV	8.35	8.66	7.86	8.48	8.72	8.96	10.12
DEC	8.76	9.11	8.22	8.99	9.11	9.11	10.08
JAN	**9.12**	**9.04**	**8.36**	**9.05**	**9.20**	**9.09**	**10.09**

CURRENT SECONDARY MARKET YIELDS

SPREADS

(Basis Points)

1988	GNMA[3]	FNMA[3]	FHLMC[3]	GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
OCT	9.96%	9.97%	9.95%	116	117	115
NOV	9.98	9.91	9.89	102	95	93
DEC	10.26	10.24	10.22	115	113	111
JAN	**10.34**	**10.30**	**10.30**	**125**	**121**	**121**

SECONDARY MARKET ACTIVITY

(Dollars in Millions)

1988	FNMA				FHLMC				GNMA	
	Portfolio		Mortgage-Backed Securities						Pass-Through Securities	
	Commitments	Purchases	Out-Standing	Issued	Commitments To Sell	Commitments To Buy	Mortgages Purchased	Mortgages Sold	Applications	Issued
SEP	$1,439	$1,111	$167,170	$5,622	$4,234	$6,208	$4,192	$3,728	$5,975	$5,684
OCT	1,740	1,488	170,395	4,772	3,983	4,406	4,037	3,674	5,599	5,823
NOV	1,289	1,596	174,278	5,405	4,806	5,419	4,109	4,231	6,380	3,886
DEC	**1,350**	**1,726**	**178,250**	**5,434**	**NA**	**NA**	**NA**	**NA**	**3,719**	**4,856**
1988 TOTAL	23,435	23,110	---	54,878	NA	NA	NA	NA	58,579	56,532
1987 TOTAL	25,415	20,531	---	63,230	68,210	76,615	76,840	75,018	116,611	96,983
12 MONTH AVG.[4]										
1988	1,953	1,926	---	4,573	3,483	5,084	3,476	3,115	4,882	4,711
1987	2,118	1,711	---	5,269	6,008	6,999	6,689	6,529	9,718	8,082
1986	2,749	2,569	---	5,047	8,909	11,985	8,379	8,259	12,742	8,181

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES

(Units in Thousands, Seasonally Adjusted Annual Rates)

	BY TYPE OF UNIT						BY REGION							
	HOUSING STARTS			BUILDING PERMITS			HOUSING STARTS				BUILDING PERMITS			
1988	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units	Northeast	Midwest	South	West	Northeast	Midwest	South	West
SEP	1,467	1,106	361	1,394	1,049	345	208	259	573	427	192	251	547	404
OCT	1,533	1,199	334	1,516	1,110	406	200	271	583	479	218	262	564	472
NOV	1,558	1,205	353	1,516	1,129	387	224	263	611	460	205	245	573	493
DEC	**1,524**	**1,180**	**344**	**1,544**	**1,145**	**399**	**179**	**329**	**589**	**427**	**192**	**360**	**550**	**442**
1988 TOTAL	1,487	1,139	348	1,460	1,082	378	235	273	575	405	232	268	546	413
1987 TOTAL	1,621	1,212	409	1,535	1,114	421	269	298	634	420	272	282	575	406
12 MONTH AVG. (SAAR)														
1988	1,491	1,147	344	1,449	1,079	370	241	273	572	406	235	269	539	406
1987	1,634	1,222	412	1,543	1,122	421	272	309	632	421	275	289	572	406
1986	1,812	1,268	545	1,771	1,185	586	299	300	731	483	282	291	686	512

HOME SALES

(Units in Thousands)

	EXISTING HOMES			NEW HOMES		
1988	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate
SEP	3,670	2,420	7.9	691	361	6.5
OCT	3,670	2,925	7.4	722	354	6.0
NOV	3,670	2,550	8.3	665	364	6.8
DEC	**4,090**	**2,080**	**6.1**	**669**	**366**	**6.7**
1988 TOTAL	3,630	---	---	677	---	---
1987 TOTAL	3,526	---	---	671	---	---
12 MONTH AVG. (SAAR)						
1988	3,593	---	---	678	---	---
1987	3,526	---	---	671	---	---
1986	3,563	---	---	745	---	---

VALUE OF NEW PRIVATE CONSTRUCTION PUT IN PLACE

(Units in Billions of 1982 Dollars, Seasonally Adjusted Annual Rates)

1988	Total[5]	1−Unit	2+ Units	Nonresidential
SEP	$283.3	$103.2	$19.3	$76.6
OCT	285.5	104.7	19.1	77.7
NOV	286.9	106.7	19.0	77.7
DEC	**289.9**	**107.8**	**18.6**	**80.2**
1988 TOTAL	282.0	103.6	19.3	78.1
1987 TOTAL	283.0	100.7	22.4	78.2
12 MONTH AVG. (SAAR)				
1988	283.0	103.6	19.2	77.9
1987	282.4	100.6	22.5	78.1
1986	281.3	91.6	27.9	80.0

LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED
By Type of Institution and By Type of Unit

(Dollars in Millions)

	1-4 UNITS					5+ UNITS					NONRESIDENTIAL				
1988	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies
JUL	$35,244	$7,685	$17,341	$9,514	$393	$3,631	$837	$1,593	$688	$372	$14,249	$128	$1,911	$10,374	$1,673
AUG	39,541	9,057	20,232	9,537	336	3,368	278	1,918	609	394	15,740	156	2,175	11,021	2,244
SEP	36,328	8,690	18,176	8,737	342	3,405	259	1,933	550	351	10,585	117	1,938	6,263	2,131
OCT	**30,578**	**6,273**	**16,053**	**7,586**	**332**	**2,707**	**327**	**1,559**	**344**	**247**	**15,669**	**84**	**2,037**	**10,501**	**2,936**
1987 TOTAL	449,544	110,093	208,054	124,551	3,209	44,981	2,409	22,492	8,299	3,547	168,652	2,871	25,613	110,490	28,160
1986 TOTAL	455,054	131,628	207,182	108,613	3,814	49,868	7,172	22,769	7,176	3,723	147,374	4,084	27,306	83,929	29,906
10 MONTH AVG. 1988	31,426	7,342	15,503	7,980	252	2,996	352	1,632	546	283	14,432	79	1,907	10,154	2,102
1987	39,288	9,806	17,950	10,953	287	3,880	216	1,874	709	284	13,329	268	2,061	8,815	2,129
1986	36,609	10,634	14,314	8,551	311	3,847	606	1,471	558	284	10,727	308	2,041	6,180	2,028

MORTGAGE INSURANCE

(Units in Thousands, Dollars in Millions)

	APPLICATIONS RECEIVED (Units)				LOANS INSURED							
1988	TOTAL	FHA[8]	VA	PRIVATE	TOTAL		FHA		VA		PRIVATE	
					Units	Amount	Units	Amount	Units	Amount	Units	Amount
SEP	141	72	19	50	117	$8,732	59	$3,655	20	$1,505	38	$3,572
OCT	135	70	19	46	129	9,468	75	4,642	18	1,389	36	3,437
NOV	**126**	**69**	**17**	**40**	**92**	**7,006**	**41**	**2,535**	**18**	**1,334**	**33**	**3,137**
DEC	**116**	**58**	**18**	**40**	**106**	**7,846**	**57**	**3,501**	**18**	**1,368**	**31**	**2,977**
1988 TOTAL	1,753	949	210	595	1,421	102,636	776	47,204	211	15,772	434	39,660
1987 TOTAL	2,340	1,211	408	721	2,282	159,668	1,320	81,881	451	33,312	511	44,475
12 MONTH AVG. 1988	146	79	18	50	111	8,167	58	3,548	18	1,314	35	3,305
1987	195	101	34	60	190	13,306	110	6,823	38	2,776	43	3,706
1986	273	159	34	77	154	10,646	77	4,742	29	2,060	49	3,845

NA—Not Available; SAAR—Seasonally Adjusted Annual Rate

[1] Secondary market gross yields. Numbers shown for each month are the average of yields from the first day of the month shown and the first day of the subsequent month.

[2] Effective rate on loans closed.

[3] Securities for 0 to 30 day delivery.

[4] Average covers one month less for FHLMC.

[5] In addition to the categories of private construction shown, the total also includes these categories: residential improvements, railroads, electric light and power, gas, telephone and telegraph, petroleum pipelines, and farm nonresidential.

[6] In addition to the categories shown, the total also includes private pension funds, private MBS conduits, state and local retirement funds, Federal credit agencies, mortgage pools, and state and local investment agencies.

[7] Savings & Loans and Mutual Savings Banks.

[8] FHA applications received includes the Direct Endorsement Program.

NOTE

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APRIL 1989

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CONTENTS

APRIL 1989 VOLUME 49 NUMBER 7

COVER: SECONDARY MORTGAGE MARKET

Evaluating the contents inside, some secondary mortgage packaging are great opportunities; in others great risks. Care must be selected in choosing the right parcel and knowing what to do with the contents once the package is opened.

13 **Building Servicing Value Through Secondary Market Decisions** *Whatever sales option is selected, the care and storing of servicing agreements is of utmost importance* By MARY BRUCE BATTE

25 **Weighing Risks** *Volatility and pervasive price competition means constant diligence required.* By JOHN J. JACOBS

31 **The Great Conversion** *Ginnie Mae secondary market transfers have steadily increased with "churning," a major factor.* By GEORGE S. ANDERSON

38 **Avoiding Legal Pitfalls** *Multi-million dollar lawsuits can result if an effective participation agreement is lacking.* By HENLEY L. SALTZBURG

Marketing

42 **The "New" Mortgage Face** *To woo and win consumers, mortgage marketers are using retail advertising techniques.* By HOWARD SCHNEIDER

Income Property

49 **Affordable Housing** *With the right partners, a mortgage company can do more than produce a good bottom line.* By KAREN KOLLIAS AND JOSEPH TOCKARSHEWSKY

55 **Why a Participating Second Mortgage?** *For those who know how to shop, they offer many advantages.* By PEGGY STEWART AND DAVID BECKERMAN

Servicing

61 **Understanding Servicing Value** *To put together the right portfolio for sale, servicers need to keep track of all components.* By JOHN S. HOPKINS, JR.

State of the Industry

67 **Avoiding Mortgage Roulette** *Mortgage firms of the future will have a number of common quality characteristics.* By VICTOR H. SCHLESINGER

Executive Essay

75 **Ten Keys to Success in Mortgage Banking** *There are trends to watch out for, as well as the right management talents.* By MARTIN D. NASS

DEPARTMENTS

9 LETTERS
11 BUSINESS ALERT
77 PEOPLE
79 THE SECONDARY MARKET
81 ECONOMIC TRENDS
86 INDEX TO ADVERTISERS

COVER ILLUSTRATION BY LINA CHESAK

Secondary Markets: Risks and Opportunities

What's going on in the secondary market?

Plenty. Two years ago, requests for transfers of issuer responsibility coming into Ginnie Mae were few and far between. Now, according to George Anderson ("The Great Conversion"), there's an avalanche. Why? You may find his answer interesting, just as you may appreciate why Mary Bruce Batte ("Building Servicing Value through Secondary Market Decisions") believes it is a major mistake for secondary marketing executives to overlook the opportunities available in a firm's servicing portfolio. In the area of selling servicing, John S. Hopkins, Jr., explains why value tracking is important. While there are opportunities galore in the secondary market, there's also a good deal of risk, as explained by Henley Saltzburg ("Avoiding Legal Pitfalls"), who details the legal danger zones and how to avoid them.

The latter dangers underscore what both Victor Schlesinger ("Avoiding Mortgage Roulette") and Martin Nass ("Ten Keys to Success in Mortgage Banking") have to say about what mortgage bankers need to do today to prosper in the future. That lesson is also brought home by Howard Schneider who explains how the lessons of consumer selling are being applied to mortgage lending. John J. Jacobs ("Weighing Risks") explains what risks to avoid in a period of high volatility and pervasive pricing competition. Another area not to overlook, according to Peggy Stewart and David Beckerman ("Why a Participating Second Mortgage?") is participation in secondary mortgage packages.

One other offering for April concerns affordable housing. Karen Kollias and Joseph Tockarshewsky ("Affordable Housing") show what an effective housing partnership can accomplish.

Janet Reilley Hewitt
Editor

COMING IN MAY

Single-Family Housing Outlook

Demographics, culture, federal housing and monetary policies—all have a massive impact on single-family housing. In May, a number of experts explore what current trends mean to mortgage bankers. We'll also take a good look at what home builders seek when they select a mortgage company to do business with.

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GNMA servicing transfers have zoomed with "churning" a major cause.

THE GREAT CONVERSION, *or How to Make Something from Nothing*

The last two years have seen an explosion in transfers of issuer responsibility (TIR), or servicing, from one approved Ginnie Mae issuer to another. The number of transfer requests, the number of pools, and the dollar amount of outstanding securities transferred per month since March 1983, when such statistics were compiled, have all steadily increased. Table 1 illustrates these increases in calendar year 1988, the dollar volume of TIRs was $62 billion, two and a half times that of 1986 and nearly five times that of 1984. Similarly, the increase in the number of TIR requests jumped from 231 in 1986 to 682 in 1988.

The increase in transfers among issuers concerns many observers in the government and the mortgage banking industry. To address this concern it is helpful to examine the history of this practice and some of the possible causes and implications.

Pre-April 1987

From the beginning of the mortgage-backed securities program, Ginnie Mae considered a responsible issuer to be one that either originated or acquired mortgage loans for pooling in Ginnie Mae securities for the explicit purpose of developing a source of long-term servicing income. To Ginnie Mae, the term issuer was synonymous with servicer. Therefore, in the early years of the program, whenever an issuer requested to transfer this all-important servicing responsibility and source of income it was construed as a request to leave the Ginnie Mae MBS program. TIRs prior to 1979 were rare occurrences.

Each request for a TIR had to be accompanied by a business reason for the transfer that indicated it was not a routine, recurring transaction. Ginnie Mae explicitly stated in its approval letters that such transfers could not be a routine or recurring event in the business activities of the issuer. The customary reasons for a TIR were: 1) a consolidation of entities; 2) voluntary termination of issuer status in the Ginnie Mae program; 3) diversification of servicing portfolio; 4) conversion of "off-balance sheet assets" to raise cash; and 5) involuntary termination of issuer status. The common denominator of all these reasons was that each had an infrequent or non-recurring nature.

Throughout the 1983 through 1986 period, mortgage interest rates were on a roller coaster ride with the deep descent beginning in 1986, a boom year for mortgage bankers compared with 1985. Consequently, mortgage bankers were making 49.5 percent more profits on mortgages sold in 1986 than in 1985 while the income from non-recurring gains fell by 60.8 percent over 1985.

Such a decline in the amount of non-recurring gains suggests that issuers were not using sales of servicing as a major source of income during the year. This opinion is bolstered by the fact that the amount of Ginnie Mae servicing transferred in 1986 was nearly equal to that of 1985 at $24.7 billion and $24.6 billion, respectively.

By year-end 1986, FHA mortgage interest rates had fallen to 9.21 percent from 10.70 percent one year earlier. That rate fell to a low of 8.79 percent in January 1987, inched up to 8.94 percent in February and March, and then, without any warning, vaulted to 10.02 percent in April 1987.

Post-April 1987

The full percentage point increase in the FHA rate in April 1987 was followed by another half point jump to 10.5 percent. The rate then remained at that level for the remainder of the year. Ginnie Mae issuers, like most mortgage bankers, traditionally hedged that portion of their production pipeline that was expected to go to actual mortgage closing, that is, potential homebuyers settling on the of-

George S. Anderson

fered mortgage from the lender. Although no firm figures are available, this proportion has been stated to be about 80 percent of all offered loans. That portion of an issuer's pipeline could be covered by a forward contract with an investor to purchase the Ginnie Mae security at a fixed price at some future date. Such action protects the issuer from interest rate movements during the production period. Some issuers interpreted the 1986 decline in interest rates as a signal to cut costs by not paying the price for a forward contract to deliver securities. That decision must have been based upon a belief that interest rates were stable or would rise gradually.

However, when the mortgage interest rates jumped as dramatically as they did in 1987, most lenders were financially hurt, both the risk-adverse and the risk-taking to varying degrees and consequences. The losses occurred when the 20 percent of homebuyers who normally would not accept the offered mortgage did choose to close in order to obtain a lower interest rate mortgage. Lenders were forced to close home loans at below current market rates without any forward protection from the secondary mortgage market. They were then faced with the costly task of selling a below market interest rate mortgage in a competitive marketplace. In order to obtain current market yield, the market discounted the below market mortgage or security. This meant that the issuer received considerably less than 100 percent for its mortgage or security and experienced an actual overall loss on closed loans.

These secondary market losses or reduced earnings created a severe earnings and cash flow strain on the mortgage banking industry. Many issuers turned to the previously untapped resource of Ginnie Mae servicing, as well as other servicing as a major source of cash for operations.

During 1987, requests for TIRs jumped 58 percent from 231 to 366. Ginnie Mae responded to issuers' requests to transfer servicing of pools that were not finally certified with the Addendum to the Assignment Agreement (AAA) or the famous "yellow sheet." (Final certification of pools is performed by document custodians who state to Ginnie Mae that there is acceptable evidence of FHA insurance or VA guaranty for pooled loans.) The AAA was a three-way agreement among the seller and buyer of pools not finally certified and Ginnie Mae. Both buyer and seller agreed that all pools would be finally certified within 12 months of the transfer date of the pools. A letter of credit issued by a bank with a Moody's long-term deposit rating of A-1 or better was posted as collateral for the timely completion of final certifications by either the seller or the buyer.

On April 5, 1988, Ginnie Mae revised its longstanding policy of discouraging routine TIRs to enable issuers to more freely transfer servicing for pools not finally certified without posting a letter of credit as collateral. Ginnie Mae also formally recognized that TIRs were now a recurring part of issuers' business practices. Issuers were allowed to transfer pools that were no less than three months old nor more than 18 months at time of transfer. Issuers could not transfer pools that were not finally certified more

TABLE 1

Transfers of Issuer Responsibility

for the period 1983 through 1988
As of 1/13/89

Period	Number of Transactions	Number of Pools	Number Dollar Amount of Transfers
03/01/83	8	168	218,556,787.30
04/01/83	12	718	991,611,379.16
05/01/83	16	611	1,748,673,820.90
06/01/83	11	363	701,343,770.05
07/01/83	13	1,010	1,987,199,326.37
08/01/83	6	283	312,456,882.24
09/01/83	23	1,699	3,088,762,541.45
10/01/83	10	216	428,277,562.36
11/01/83	9	234	396,084,416.45
12/01/83	10	253	548,914,466.53
Total	118	5,555	$10,421,880,951.81
01/01/84	18	1,139	2,219,531,769.30
02/01/84	6	103	141,811,336.29
03/01/84	18	427	769,925,228.79
04/01/84	9	189	370,844,381.77
05/01/84	7	48	74,050,102.99
06/01/84	18	437	881,349,885.87
07/01/84	29	1,375	2,232,587,977.82
08/01/84	23	511	785,151,246.76
09/01/84	27	739	1,268,568,311.27
10/01/84	17	1,071	2,124,028,982.12
11/01/84	36	654	1,547,776,076.04
12/01/84	14	329	700,457,416.87
Total	222	7,022	$13,116,082,715.89
01/01/85	30	2,401	5,563,026,057.44
02/01/85	22	881	1,478,488,952.99
03/01/85	22	958	3,860,456,858.45
04/01/85	24	1,154	2,618,697,568.45
05/01/85	10	573	160,211,724.33
06/01/85	24	1,019	1,736,486,528.55
07/01/85	23	815	1,685,781,446.46
08/01/85	11	860	1,445,657,239.58
09/01/85	4	105	267,861,321.55
10/01/85	53	2,319	3,679,166,227.48
11/01/85	5	11	25,248,731.71
12/01/85	30	1,204	2,051,564,237.90
Total	258	12,300	$24,572,646,894.89
01/01/86	17	2,412	4,715,150,024.15
02/01/86	12	665	1,321,904,865.00
03/01/86	12	137	173,382,849.02
04/01/86	25	725	1,023,606,318.83
05/01/86	13	400	562,498,571.06
06/01/86	15	380	863,038,526.55
07/01/86	20	1,049	661,076,247.97
08/01/86	18	2,411	4,466,649,726.16
09/01/86	40	1,231	2,038,472,163.52
10/01/86	8	61	64,262,700.96
11/01/86	31	3,376	5,805,011,487.08
12/01/86	20	2,415	3,033,521,446.24
Total	231	15,262	$24,728,574,926.54
01/01/87	29	2,261	4,713,975,040.53
02/01/87	12	293	362,705,257.73
03/01/87	17	689	875,037,416.48
04/01/87	20	795	1,128,024,973.27
05/01/87	38	659	1,658,889,326.28
06/01/87	19	2,246	4,577,350,008.25
07/01/87	15	485	1,025,781,796.75
08/01/87	9	398	1,685,646,036.73
09/01/87	53	3,585	5,827,453,951.06
10/01/87	0	0	0.00
11/01/87	58	4,494	8,272,129,013.01
12/01/87	96	7,243	12,616,685,450.30
Total	386	23,148	$42,733,678,270.39
01/01/88	44	1,839	4,103,595,218.12
02/01/88	16	341	776,600,440.48
03/01/88	82	3,630	7,468,082,662.96
04/01/88	78	3,144	5,998,593,378.67
05/01/88	63	2,702	4,736,898,641.28
06/01/88	65	2,706	5,473,325,798.50
07/01/88	42	2,452	5,507,542,031.41
08/01/88	72	3,937	7,506,447,397.14
09/01/88	65	2,512	5,390,645,906.12
10/01/88	49	2,871	4,924,064,627.27
11/01/88	61	3,069	4,907,990,107.55
12/01/88	45	2,018	5,276,495,535.81
Total	682	31,221	$62,070,281,744.31
Grand Total	1,877	94,508	$177,843,145,504.83

Note: Transactions include only "sell" actions.
Source: Ginnie Mae

TABLE 2

Summary Comparison of Ratios of Portfolios Bought and Sold

for Calendar Years 1983 through 1988
As of 1/13/89

% Difference Between Amounts Bought & Sold	Number of Issuers 1983	1984	1985	1986	1987	1988
0.0-4.99	1	2	2	5	2	9
5.0-9.99	0	1	0	4	0	2
10.0-24.99	0	1	0	1	5	4
25.0-49.99	1	1	3	3	7	18
50.0-99.99	5	14	23	19	43	94
Sub-Total	7	19	28	32	57	127
Sold Only	84	124	139	112	169	246
Bought Only	61	82	83	77	108	112
No Transactions	716	663	618	647	534	383
Number Issuers Buying/Selling	152	205	250	221	334	485

Source: Ginnie Mae

than once until they were finally certified.

Furthermore, Ginnie Mae eliminated the routine practice of requesting extensions for final certification of pools and extended the standard 90-day period for obtaining final certifications to 18 months without extension. Issuers are required to obtain final certification of all pools by the 18th month of its issuance. As a consequence of the liberalized transfer rules, Ginnie Mae found itself deluged by requests to transfer servicing. In order to provide timely service to the issuer community Ginnie Mae automated the transfer process with its Pool Transfer System (PTS) that required issuers to submit requests on a floppy diskette for TIRs involving 10 or more pools.

After the April 1987 interest rate spike, the most often cited reason for requesting a TIR was to provide cash for operations. This change in purpose is evidenced in the MBA's financial statement survey for 1987 where income from net non-recurring gain per firm reporting jumped from $109,000 to $2.123 million for the years 1986 and 1987, respectively. This represented a 1,847 percent increase from one year to the next. When asked, most issuers said that the non-recurring gain was due to the sale of servicing. The MBA's survey also points out that even with the increase in TIRs, profit margins were severely squeezed from 7.05 percent to 3.12 percent.

The question of churning

During 1988, transfers of servicing were not clearly identified with any one particular reason and because Ginnie Mae no longer required issuers to state the reason for the transfer, it is not clear what the driving forces for the TIRs were or continue to be. Due to this lack of specificity, there is room for speculation. One of the major arguments being made today is that issuers are "churning" their portfolios because of the limitations imposed by the accounting rules governing mortgage banking transactions. In particular, this school of thought argues that the combined effect of FASB Statements 65 and 91 is a possible major force behind TIRs. Simply stated, these accounting statements generally prohibit lenders from recognizing the value of mortgage servicing that is originated in-house but does permit recognition of servicing purchased from another lender. Therefore, in order to put an otherwise "non-existent" asset on the books, lenders must sell their servicing and buy servicing from another lender, thereby churning their portfolios.

The drive to put hidden assets on the income statement and balance sheet usually is accomplished by two or more issuers agreeing among themselves to buy each other's servicing. This practice, of course, is a major undertaking that affects many individuals. It has drawn negative attention from the U.S. Congress and is closely watched by the executive branch of government. Furthermore, churning is costly to the participants and adds little, if anything, to the national economy.

Ginnie Mae's database of TIRs was examined to determine if churning could be detected. For this effort, churning was defined as the relative matching of one issuer's simultaneous sale and purchase of servicing within the same calendar year. The more closely the volume of servicing sold matches the volume bought, the easier it is to label it "churning." In order to measure churning, all "buy" and "sell" transactions per issuer per year were accumulated from March 1983 through December 1988. Table 2 illustrates the results of this exercise.

When the 1,877 "sell" and 1,818 "buy" transactions for the subject period were summed by issuer by year, there were 868 different issuers out of Ginnie Mae's program total of 1,900 approved issuers that had either bought or sold Ginnie Mae servicing involving 94,508 pools and $177.6 billion. These totals include both involuntary, as well as voluntary, transfers of servicing. Involuntary TIRs over the study period were fewer than 30 separate events that included all types of issuers.

Table 2 reveals several interesting facts. The number of issuers that were in the market to both buy and sell within the same year increased from 7 in 1983 to 127 in 1988. The number of issuers that matched their sales and purchases of servicing within a 50 percent range went from 2 in 1983 to 33 in 1988. The number of issuers that only bought servicing in a single year moved from 61 to 112, an 84 percent increase, while the number who only sold servicing jumped from 84 to 246, a 193 percent increase. Clearly, 1988 was a buyer's market for Ginnie Mae servicing. Even more dramatic was the increase in the number of issuers that were in the market to either buy or sell servicing. This group leaped from 152 in 1983 to 485 in 1988, a 219 percent increase.

What does all of this mean? Is this conclusive evidence of churning? The data clearly suggest that more issuers are selling their servicing in 1988 than ever before. More issuers are matching their sales of servicing with purchases. And, more issuers are engaged in the act of either buying, selling or doing both with fewer issuers originating and holding servicing.

If the industry average price of 2 percent for Ginnie Mae servicing is applied to the servicing transferred in 1988, the mortgage banking industry converted $62 billion of a "non-existent" asset into approximately $1.2 billion of cash—who said you can't get something for nothing?

The evidence suggests that transferring servicing has become a regular part of issuers' business practices as a source of cash and recognition of servicing value. More issuers are becoming involved in the buying or selling of servicing than in the traditional practice of originating or acquiring mortgage production for the purpose of retaining the servicing. If the trend continues for more issuers to sell their servicing to a smaller group of issuers, there will be increasing concentration of servicing within the industry. There are growing pressures within the economy for greater specialization of functions. This function specialization could result in the mortgage banking industry characterized by two separate and distinct groups—those that primarily originate and those that primarily service.

Churning of portfolios could be eliminated or significantly reduced by adoption of an accepted valuation model for in-house servicing. TIRs made to generate cash for operations will remain an important part of the mortgage banker's normal business practice and will fluctuate inversely with earnings margins. **MB**

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VITAL STATISTICS

INTEREST RATES & YIELDS

1- TO 4-FAMILY MORTGAGES

	FHA OPINION SURVEY	FHLBB			FNMA		FHLMC	
1988	FHA New Homes[1]	CONVENTIONAL[2] FRM	ARM	Median Cost of Funds FSLIC Institutions	1-Yr. ARM	FRM Conv.	ARMs	FRMs
OCT	10.41%	10.69%	8.58%	7.29%	8.86%	9.97%	8.12%	10.30%
NOV	10.43	10.54	8.76	7.35	9.13	10.22	8.16	10.27
DEC	10.72	10.53	8.78	NA	9.39	10.59	8.40	10.61
JAN	10.75	10.62	8.84	7.40	9.46	10.59	8.55	10.73
FEB	**NA**	**10.81**	**9.07**	**NA**	**10.65**	**9.64**	**8.65**	**10.65**

SELECTED SECURITIES

1988	FEDERAL FUNDS RATE	PRIME COMMERCIAL PAPER (3-Month)	U.S. GOVERNMENT 6-Month	1-Year	3-Year	10-Year	A-Rated Utility
OCT	8.30%	8.24%	7.50%	8.11%	8.43%	8.80%	10.11%
NOV	8.35	8.66	7.86	8.48	8.72	8.96	10.12
DEC	8.76	9.11	8.22	8.99	9.11	9.11	10.08
JAN	9.12	9.04	8.36	9.05	9.20	9.09	10.09
FEB	**9.36**	**9.37**	**8.55**	**9.25**	**9.32**	**9.17**	**10.25**

CURRENT SECONDARY MARKET YIELDS

SPREADS

(Basis Points)

1988	GNMA[3]	FNMA[3]	FHLMC[3]	GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
NOV	9.98%	9.91%	9.89%	102	95	93
DEC	10.26	10.24	10.22	115	113	111
JAN	10.34	10.30	10.30	125	121	121
FEB	**10.37**	**10.33**	**10.33**	**120**	**116**	**116**

SECONDARY MARKET ACTIVITY

(Dollars in Millions)

	FNMA				FHLMC				GNMA	
	Portfolio		Mortgage-Backed Securities						Pass-Through Securities	
1988	Commitments	Purchases	Out-Standing	Issued	Commitments To Sell	Commitments To Buy	Mortgages Purchased	Mortgages Sold	Applications	Issued
OCT	$1,740	$1,488	$170,395	$4,772	$3,850	$5,294	$4,037	$3,674	$5,599	$5,823
NOV	1,289	1,596	174,278	5,405	3,759	7,156	4,109	4,231	6,380	3,886
DEC	1,350	1,726	178,250	5,434	5,888	10,101	5,842	5,511	3,719	4,856
JAN	**1,087**	**1,037**	**180,822**	**4,101**	**NA**	**NA**	**NA**	**NA**	**4,830**	**4,584**
1988 TOTAL	23,435	23,110	---	54,878	43,017	68,650	44,075	39,776	58,579	56,532
1987 TOTAL	25,415	20,531	---	63,230	68,210	76,615	76,840	75,018	116,611	96,983
1 MONTH AVG.[4]										
1989	1,087	1,037	---	4,101	NA	NA	NA	NA	4,830	4,584
1988	2,254	1,267	---	1,623	2,096	3,867	2,168	1,832	1,651	4,348
1987	948	1,346	---	6,363	7,455	8,003	7,950	8,215	13,932	10,452

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES

(Units in Thousands, Seasonally Adjusted Annual Rates)

BY TYPE OF UNIT

	HOUSING STARTS			BUILDING PERMITS		
1988	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units
OCT	1,532	1,199	333	1,516	1,110	406
NOV	1,567	1,206	361	1,516	1,129	387
DEC	1,568	1,189	379	1,564	1,162	404
JAN	**1,693**	**1,274**	**419**	**1,523**	**1,153**	**370**
1988 TOTAL	1,488	1,139	349	1,460	1,082	378
1987 TOTAL	1,621	1,212	409	1,535	1,114	421
1 MONTH AVG. (SAAR)						
1989	1,693	1,274	419	1,523	1,153	370
1988	1,382	1,069	313	1,248	988	260
1987	1,804	1,324	480	1,692	1,194	498

BY REGION

	HOUSING STARTS				BUILDING PERMITS			
1988	Northeast	Midwest	South	West	Northeast	Midwest	South	West
OCT	198	273	582	479	218	262	564	472
NOV	219	275	613	460	205	245	573	493
DEC	195	345	598	430	207	257	566	436
JAN	**296**	**332**	**616**	**449**	**234**	**301**	**572**	**416**
1988 TOTAL	235	273	575	405	232	268	546	413
1987 TOTAL	269	298	634	420	272	282	575	406
1 MONTH AVG. (SAAR)								
1989	296	332	616	449	234	301	572	416
1988	306	226	463	387	264	230	420	334
1987	342	426	587	449	288	353	571	480

HOME SALES

(Units in Thousands)

	EXISTING HOMES			NEW HOMES		
1988	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate
OCT	3,670	2,925	7.4	718	353	6.1
NOV	3,670	2,550	8.3	658	364	6.8
DEC	3,920	2,160	6.5	671	367	6.7
JAN	**3,630**	**2,260**	**7.5**	**704**	**371**	**6.3**
1988 TOTAL	3,630	---	---	677	---	---
1987 TOTAL	3,526	---	---	671	---	---
12 MONTH AVG. (SAAR)						
1989	3,630	---	---	704	---	---
1988	3,170	---	---	579	---	---
1987	3,520	---	---	719	---	---

VALUE OF NEW PRIVATE CONSTRUCTION PUT IN PLACE

(Units in Billions of 1982 Dollars, Seasonally Adjusted Annual Rates)

1988	Total[5]	1-Unit	2+ Units	Nonresidential
OCT	$285.5	$104.7	$19.1	$77.7
NOV	288.1	106.7	19.1	77.6
DEC	290.4	107.6	19.0	79.1
JAN	**296.0**	**107.9**	**19.7**	**82.6**
1988 TOTAL	282.0	103.6	19.3	78.1
1987 TOTAL	283.0	100.7	22.4	78.2
12 MONTH AVG. (SAAR)				
1989	296.0	107.9	19.7	82.6
1988	280.6	103.5	21.0	76.9
1987	282.3	98.9	25.6	75.6

LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED
By Type of Institution and By Type of Unit

(Dollars in Millions)

	1-4 UNITS					5+ UNITS					NONRESIDENTIAL				
1988	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies
AUG	$39,541	$9,057	$20,232	$9,537	$336	$3,368	$278	$1,918	$609	$394	$15,740	$156	$2,175	$11,021	$2,244
SEP	36,328	8,690	18,176	8,737	342	3,405	259	1,933	550	351	10,585	117	1,938	6,263	2,131
OCT	30,578	6,273	16,053	7,586	332	2,707	327	1,559	344	247	15,669	84	2,037	10,501	2,936
NOV	**28,138**	**5,430**	**14,704**	**7,314**	**352**	**3,406**	**600**	**1,605**	**659**	**271**	**11,252**	**23**	**1,496**	**6,546**	**3,090**
1987 TOTAL	449,544	110,093	208,054	124,551	3,209	44,981	2,409	22,492	8,299	3,547	168,652	2,871	25,613	110,490	28,160
1986 TOTAL	455,054	131,628	207,182	108,613	3,814	49,868	7,172	22,769	7,176	3,723	147,374	4,084	27,306	83,929	29,906
11 MONTH AVG. 1988	31,127	7,168	15,430	7,920	261	3,034	375	16,299	551	303	14,143	73	1,869	9,826	2,192
1987	38,154	9,410	17,571	10,596	281	3,772	210	18,337	697	377	13,504	251	2,055	8,888	2,200
1986	36,852	10,771	16,746	8,692	320	3,815	568	16,731	547	290	11,212	321	183	6,418	2,229

MORTGAGE INSURANCE

(Units in Thousands, Dollars in Millions)

	APPLICATIONS RECEIVED (Units)				LOANS INSURED							
1988	TOTAL	FHA[8]	VA	PRIVATE	TOTAL		FHA		VA		PRIVATE	
					Units	Amount	Units	Amount	Units	Amount	Units	Amount
OCT	135	70	19	46	129	$9,468	75	$4,642	18	$1,389	36	$3,437
NOV	126	69	17	40	92	7,006	41	2,535	18	1,334	33	3,137
DEC	116	58	18	40	106	7,846	57	3,501	18	1,368	31	2,977
JAN	**107**	**60**	**16**	**31**	**121**	**9,008**	**76**	**4,628**	**17**	**1,240**	**28**	**3,140**
1988 TOTAL	1,753	949	210	595	1,421	102,636	776	47,204	211	15,772	434	39,660
1987 TOTAL	2,340	1,211	408	721	2,282	159,668	1,320	81,881	451	33,312	511	44,475
1 MONTH AVG. 1989	107	60	16	31	176	12,233	96	5,955	38	2,717	42	3,561
1988	---	58	14	38	120	8,246	74	4,453	16	1,143	30	2,650
1987	207	120	41	47	176	12,233	96	5,955	38	2,717	42	3,561

NA—Not Available; SAAR—Seasonally Adjusted Annual Rate

[1] Secondary market gross yields. Numbers shown for each month are the average of yields from the first day of the month shown and the first day of the subsequent month.

[2] Effective rate on loans closed.

[3] Securities for 0 to 30 day delivery.

[4] Average covers one month less for FHLMC.

[5] In addition to the categories of private construction shown, the total also includes these categories: residential improvements, railroads, electric light and power, gas, telephone and telegraph, petroleum pipelines, and farm nonresidential.

[6] In addition to the categories shown, the total also includes private pension funds, private MBS conduits, state and local retirement funds, Federal credit agencies, mortgage pools, and state and local investment agencies.

[7] Savings & Loans and Mutual Savings Banks.

[8] FHA applications received includes the Direct Endorsement Program.

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MORTGAGE BANKING

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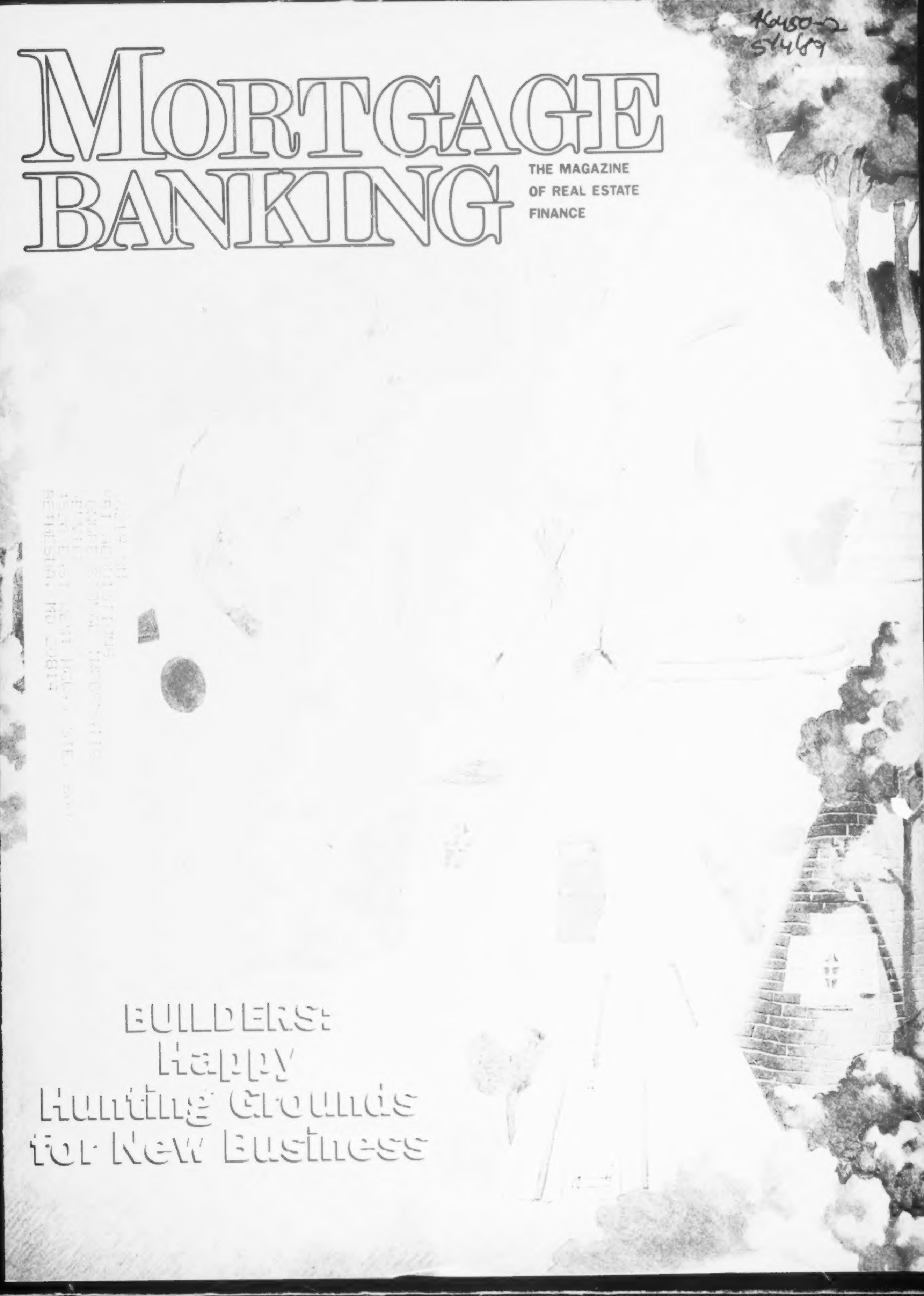


BUILDERS:
Happy Hunting Grounds for New Business

CONTENTS

MAY 1989 VOLUME 49 NUMBER 8

COVER: Single-Family Housing

Out of the uncertainties involved in the S&L crisis, there are a few absolutes. The days of predatory pricing are just about over and there will be a new, more level playing field. Home builders don't want to be caught without funding options and mortgage bankers are high on the option list. As one home builder says, it's a world of opportunities.

12 **Home Builders Seek New, Savvy Lender Partners** *As this spring selling seasons begins, home builders are already looking forward to next year's offerings with a major question on their minds. Who will be their lending source?* By JOE C. DAWSON

21 **The Debate Over FHA Liberalization** *A debate is occurring over whether the liberalization of FHA ceilings will help first-time homebuyers. All the affordability problems may not be solved, but it is a step in the right direction.* By LINDA McKENNA

Marketing

24 **Niche Marketing** *Two mortgage firms use effective customer service as a base for solid, rapid growth.*

State of the Industry

30 **A New Paradigm for Lenders** *The mortgage banking business has been evolving almost since its inception. What it looks like tomorrow will differ from the way it looks today.* By JOSEPH GARRETT

International Finance

40 **England's Secondary Squeeze** *England used to be a slow moving gentleman's mortgage market. Not any longer.* By ROBERT S. ENGLAND

48 **Why Japan Likes U.S. Real Estate** *There are many reasons, not all of them well understood, behind Japan's interest in American real estate.* By VICTOR E.J. ORTH

Technology

65 **Data Processing Costs** *The way a financial lending institution handles data processing costs can have a beneficial impact.* By RUTH H. BULLARD, DIANE B. WALZ, ROGER BOMELY AND DENNIS M. BLINE

Executive Essay

73 **Servicing Release** *With a major portion of new business coming from referrals and word of mouth, real estate finance executives need to take care that servicing is up to par.* By JOHN J. SOUSA, JR.

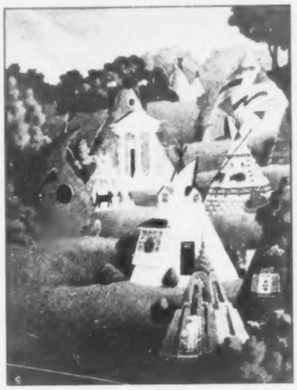
DEPARTMENTS

9 **BUSINESS ALERT**
76 **PEOPLE**
79 **THE SECONDARY MARKET**
81 **ECONOMIC TRENDS**
86 **INDEX TO ADVERTISERS**

COVER ILLUSTRATION BY ANNIE LUNSFORD

PORTFOLIO

The S&L Fallout



The S&L crisis is surrounded by so many uncertainties that even experts who follow the developments daily have a hard time fully coping with the potential meaning of today's events. Every day, the media delivers new reports that suggest the resolution of the crisis may profoundly reshape the way mortgage bankers do business.

In reporting what these experts are saying, we face two understandable constraints. For one, there are occasions when an authority wishes to "go off the record" to discuss a delicate matter. Secondly, sources dip into more colorful vocabulary to describe their feelings about the crisis, and that of course must be edited out.

We do our best to ensure that our readers don't lose the substance covered in these exchanges. For instance, in this month's cover story on how home builders are seeking alternate sources of funding in the wake of thrift closings, we didn't quote the vernacular. But, if we did our job well, the sense of frustration and anxiety that many builders conveyed should be apparent. Similarly, without naming names, the message should be communicated that a few builders do not have much respect for the political process. Out of all this, our readers should gain this important insight: home builders want to talk business with mortgage bankers. But, if mortgage bankers want the business, they need to understand a builder's needs and be able to speak their language.

Other important articles in this issue on single-family lending should not be overlooked. Customer relations emerge as paramount in both the niche marketing articles featuring two innovative lenders, and in the essay by John J. Sousa, president of Commonwealth Mortgage Company of Wellesley Hills, Massachusetts. Joseph Garrett of the Hamilton Savings Bank in San Francisco discusses the evolution and future of mortgage banking, and MBA's Linda McKenna looks at the debate surrounding legislation that would liberalize FHA terms.

Janet Reilley Hewitt
Editor

COMING IN JUNE

Mortgage Banking's Bread and Butter

Servicing—a mortgage banker's bread and butter—will be served up for discussion in June. How to spot default risks tied to your correspondents and how to hedge servicing value to guard against balance sheet hits, are just two of the topics we will dig our teeth into in the next issue.

MORTGAGE BANKING
THE MAGAZINE OF REAL ESTATE FINANCE

VOLUME 49 NUMBER 8

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The proposed National Affordable Housing Act, while not a panacea, is a step in the right direction for first-time homebuyers.

THE DEBATE OVER FHA LIBERALIZATION

Linda McKenna

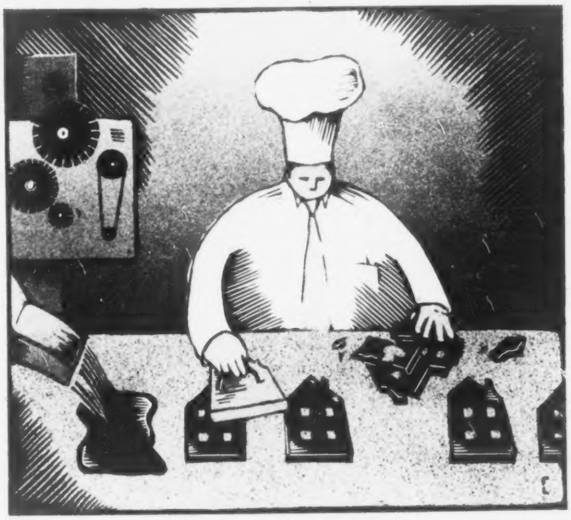


ILLUSTRATION BY RANDY LYHUS

The visibility of homelessness today has put housing at the forefront of national issues. Ironically, if it were not for the dire circumstances faced by this unfortunate sector of the population, the unmet housing needs of many other Americans would not have reached the level of public awareness it has today. The housing problem affects all types of housing, from the availability of temporary shelter to homeownership; and it touches a broad segment of our society, hitting those of low- and moderate- income the hardest.

Homeownership is what most Americans ultimately strive for. Until 1980, the number of people attaining this goal had been on the rise. But in the 1970s and early 1980s, rapid house price appreciation, rising real interest rates, and a lag in household income growth reversed the trend. From 1980 to 1987, homeownership declined from 65.6 percent to 64 percent for the nation, most notably among those aged 25 to 34—the prime first-time homebuyer group—according to the "State of the Nation's Housing 1988" by the Joint Center for Housing Studies at Harvard.

A program that has had a far-reaching impact on facilitating homeownership affordability for more than 50 years is the Federal Housing Administration insurance program. More commonly known as the FHA, the program has made it possible for more than 15 million Americans to become homeowners.

Since 1934, the FHA has served the mortgage financing needs of homebuyers, many of them first-time buyers, who could otherwise not afford to purchase a home. It has done this through a combination of lower down payment requirements, allowing the insurance premium and closing costs to be included in the financing, a longer amortization period, and slightly more liberal underwriting standards, while maintaining an actuarily sound program.

Now, however, the FHA is encountering difficulties in carrying out its objective. Speaking before the Senate Banking Committee's Subcommittee on Housing and Urban Affairs in September 1988, MBA president Willard Gourley discussed the problem.

"The maximum mortgage ceiling is intended to target FHA activity to moderate-income homebuyers. However, it is important that it have generally equitable applicability for the entire country," Gourley said. "While the indexing concept introduced in 1979 is supportable and helpful, the maximum cap of $101,250 has served to reduce the availability of FHA insurance in high-cost areas, of which there are a growing number," he added.

As a result of this cap, many first-time buyers are essentially shut out of the FHA program, and thus homeownership. (713 areas, including 7 entire states, are listed by HUD as high-cost, of which one-third allow loans up to the $101,250 ceiling.)

Currently, homeownership affordability is one of the issues before

Congress, which this year is proposing various solutions to make FHA more accessible to homebuyers in high-cost areas. Several bills have been introduced that would enable FHA insurance benefits to reach more borrowers. Provisions include raising loan limits, lowering or eliminating the down payment requirement, and allowing more flexibility in insuring ARMs.

The National Affordable Housing Act, submitted to Congress by Senators Alan Cranston (CA-D) and Alfonse D'Amato (NY-R), would set the maximum mortgage amount at 95 percent of median sales price for all areas, with no ceiling, among other provisions.

Though the MBA generally supports these innovations to the FHA program, detractors of the FHA think that the proposal to allow higher mortgage amounts will only serve to benefit upper-income Americans.

So says a recent article in *Savings Institutions*. The benefit would go to upper-income homebuyers it asserts, because they—not first-time buyers—purchase homes at prices in the range of the proposed higher loan limits. It calls for targeting the FHA program to first-time, low- and moderate-income buyers.

Admittedly, allowing loan limits to be as high as 95 percent of area median house price may not solve the affordability problem, but it will at least ensure greater access to the program by first-time homebuyers in all areas of the country.

Patric Hendershott, professor at Ohio State University, also believes loan limits should not be raised as currently proposed. "The fact that some areas have higher real incomes, or someone buys a higher quality home, doesn't mean they should be getting a bigger part of the subsidy," he told the audience at MBA's annual housing policy institute last year.

Hendershott argues that because higher incomes and demand for greater amenities are skewing house prices, these factors must be accounted for in determining FHA loan limits. His solution: base limits on the regional price of a "constant quality house"—a price index prepared by the Census Bureau that measures changes in the average sales price of new single-family houses that are the same with respect to 10 physical characteristics as houses sold in 1982.

But homebuyers are not necessarily exercising preferences for larger houses with more amenities, nor do they necessarily have higher incomes or greater purchasing power. Rather, the house price reflects the particular conditions in that market, including crucial elements Hendershott fails to mention: impact fees, government regulations, labor costs and supply of housing.

MBA research illustrates how, in major metropolitan areas, the median-priced home is, in fact, well beyond the means of those with the median household income (the measure of homeownership affordability): In 1970 the U.S. median household income was $8,734 while the median-priced existing home cost $23,000. With mortgage interest rates at 9 percent, the income needed to qualify to purchase that home was 92 percent of the median household income.

By 1987, homebuyers needed 125 percent of the median household income to qualify at the prevailing 10 percent interest rate. And the situation was even more severe in metropolitan areas such as Los Angeles where an income of 188 percent of the median income was required (see chart).

CHART 1

Homeownership Affordability

Metropolitan Area	1987 Median Household Income	1987 Median Resale Price	Qualifying Income at 10%*	Percent of Median Income	Qualifying Income at 12%*	Percent of Median Income	10% Down	Percent of Median Income
Anaheim/Santa Ana	$35,413	$167,300	$63,400	179%	$74,342	210%	$16,730	47%
Boston	$35,010	$177,200	$67,178	192	$78,741	225	$17,720	51
Chicago	$28,328	$ 90,800	$34,423	122	$40,348	142	$ 9,080	32
Dallas	$31,256	$ 89,200	$33,817	108	$39,637	127	$ 8,920	29
Denver	$28,949	$ 88,900	$33,703	107	$39,504	136	$ 8,890	31
Los Angeles/Long Beach	$29,724	$147,700	$55,995	188	$65,632	221	$14,770	50
Miami/Hialeah	$21,112	$ 81,100	$30,746	146	$36,038	171	$ 8,110	38
New York/Northern New Jersey/ Long Island	$22,834	$183,500	$69,567	305	$81,540	357	$18,350	80
Philadelphia	$28,550	$ 97,000	$36,774	129	$43,103	151	$ 9,700	34
San Diego	$30,582	$129,200	$48,981	160	$57,411	188	$12,920	42
San Francisco Bay	$35,480	$171,300	$64,942	183	$76,119	215	$17,130	48
Washington, D.C.	$44,941	$114,200	$43,294	96	$50,746	113	$11,420	25
U.S.	$25,986	$ 85,600	$32,452	125	$38,037	146	$ 8,560	33

Sources: U.S. Department of Commerce, Bureau of the Census
National Association of Realtors

*Assumes a 10 percent down payment with 25 percent of gross income devoted to principal and interest payments; does not include taxes and insurance

Though Hendershott's proposal seemingly would provide a means to set loan limits that more accurately reflect regional variations in house price, while retaining the program's objective of serving those who could not otherwise afford a home, there are problems inherent with the index.

Index problems

The first problem with the index is that price comparisons are between years not regions and for new homes only.

Second, prices are reported for the four Census regions only. (To provide this information at the metropolitan level would require significant expansion of the sample size, and the Bureau currently does not have the resources to do this.)

Third, the 10 characteristics account for only 66 percent of the variation in sales prices and so exclude such features as neighborhood quality or location. For example, a new starter home purchased with an FHA loan in a high-cost area five years ago is sold at a price far above the current FHA cap. Though it's the same quality house, the owner can sell it for a higher price because improvements in the environs have increased its value.

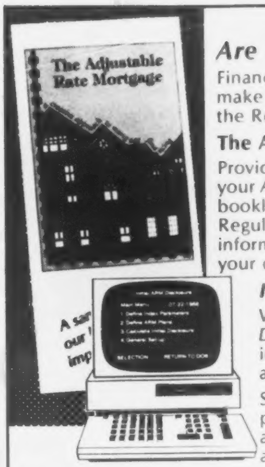
And finally, those very factors that Hendershott is trying to correct for are incorporated in the index because it is broader in coverage than a cost index, thus reflecting the demand and supply factors that affect sales price.

The role FHA should play has always been highly debated, and the proposed innovations have heightened that discussion.

Though the debate continues, Cranston and D'Amato have, after a year of intensive review based on input from housing organizations, including the MBA, and a National Housing Task Force, made up their minds on the issue. Whether the provision will survive intact remains to be seen.

Admittedly, allowing loan limits to be as high as 95 percent of area median house price may not solve the affordability problem, but it will at least ensure greater access to the program by first-time homebuyers in all areas of the country. And that, in MBA's view, is a step in the right direction. **MB**

Linda McKenna is a researcher at MBA.



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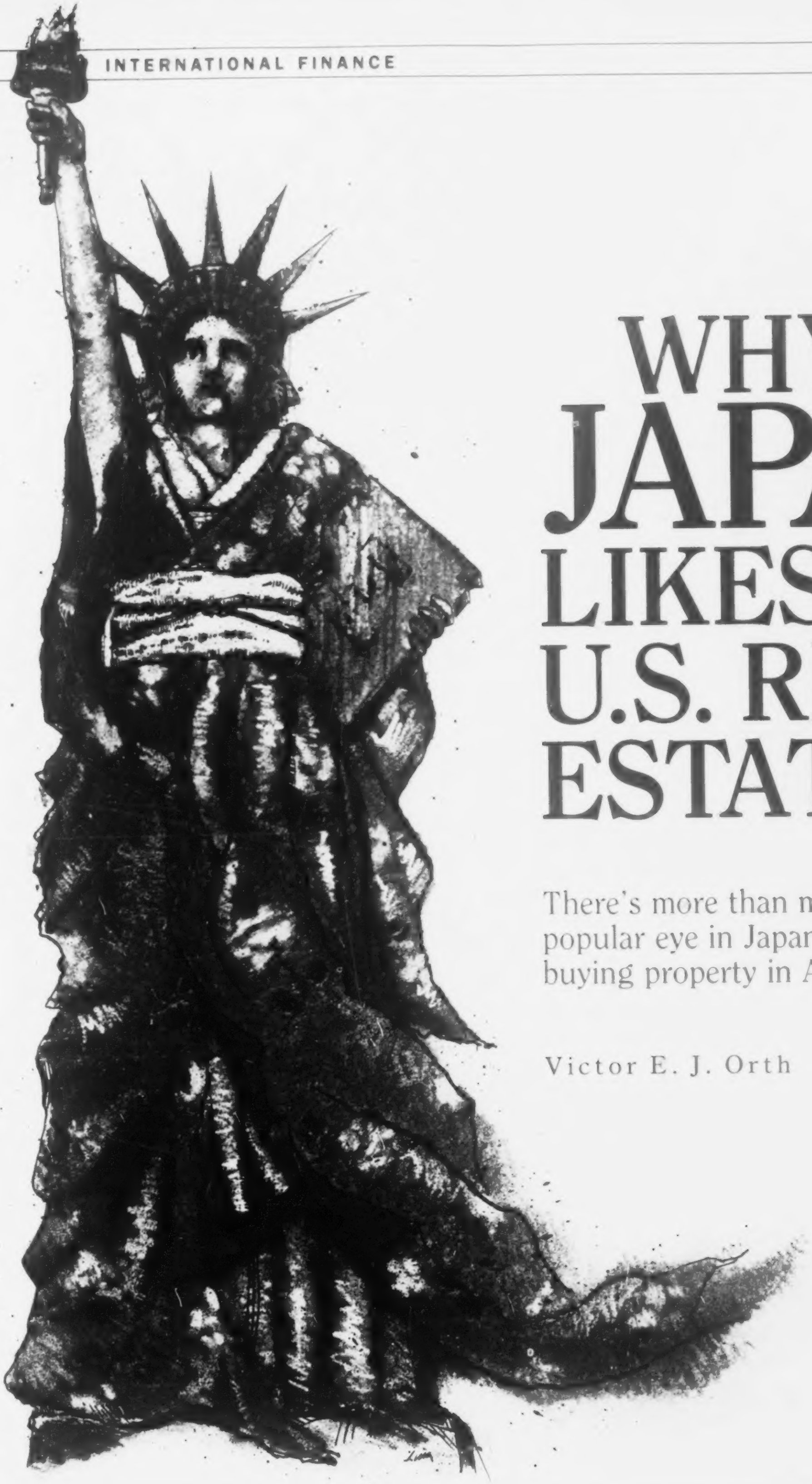

ILLUSTRATION BY LINA CHESAK

WHY JAPAN LIKES U.S. REAL ESTATE

There's more than meets the popular eye in Japan's interest in buying property in America.

Victor E. J. Orth

From the days when the continent was virgin forest, investors have been buying U.S. real estate. But over the last few years, foreign investment in U.S real estate has increased significantly. Reasons given for this increase have ranged from favorable tax structuring to perceived economic stability, and from favorable interest rates to perceived yield potential in real terms. Each company invests for reasons unique to its particular criteria for creating a favorable foreign investment.

Foreign investor-countries such as France, West Germany and Japan have invested in the United States in spite of faster rates of economic growth in their own countries. To better understand this, we must take note of the perspective, foreign business has of the United States. This perspective stems from a world of tumultuous change, political uncertainty and economic oscillation. But foreign business views the United States as a country encompassing a landscape of economic stability, political calm, and an abundant well-trained labor force with relative peace in labor/management relations. Finally, the United States has a national marketplace large enough to allow significant risk diversification.

Both direct and indirect foreign investments have increased over the last 10 years. A strong U.S. dollar and high interest rates were the primary culprits raising the cost of U.S. assets and sending foreign direct investment scurrying elsewhere.

However, due to the U.S. dollar's temporary depreciation experienced against the Japanese yen, a significant upswing in Japanese investment in the U.S. occurred. Even though U.S. property was becoming more and more expensive due to the gradual strengthening of the U.S. dollar against most foreign currencies; U.S. property was considered to be a bargain by foreign land value standards. For example, land values in Tokyo, Japan more than doubled in 1986, resulting in prime C.B.D. (central business district) land values of as much as $29,000 per square foot. Stratospheric prices such as this brought about bottom barrel yields of 1 to 2 percent on newly acquired buildings. Consequently, the Japanese real estate market was brought to a near standstill. Thus, the shining star of U.S. real estate started looking brighter and brighter to foreign investors.

Although not as large as the United Kingdom or the Dutch in total dollars invested, the Japanese have managed to capture third place with a whopping $13.2 billion in total U.S. real estate holdings. Understandably, U.S. curiosity has peaked at the sudden volume of Japanese purchases and the financial strength with which they have penetrated the U.S. market.

A recent study indicated that Japan was one of six countries responsible for approximately 90 percent of the foreign investment in U.S. real estate from 1980 to 1984. The other countries were Canada, Germany, the Netherlands, the Netherlands Antilles and the United Kingdom. Of these investors, the Japanese have captured our national business limelight. Japan's high business visibility in the U.S. is predominantly in the form of numerous articles written on various aspects of their investment activities.

Articles written about Japanese investment have included historical perspectives, Japanese investment strategies, and past, present and future income flow analysis. Numerous, step-by-step, cookbook-style articles, intending to provide readers with insight and understanding on courting Japanese investors, have been published. Not to mention the armchair psychology which has attempted to provide the psycho-analysis for our preoccupation with the Japanese investor.

In the interest of summarizing rather than expanding the field of Japanese real estate investment articles, this article will not take any of the aforementioned specialized perspectives. Rather, it will attempt to take an overview perspective of the entire U.S. Japanese real estate investment phenomenon. This will take into account past reasoning, present effects and future strategies which make up the character of this "new-found" economic force. In addition we will attempt to quantify various aspects of the Japanese value perspective as it relates to U.S. real estate investment.

In the beginning

In the beginning, God created the Earth and Man. Then Man created "real estate," and then the Japanese bought it. In the minds of many U.S. real estate investors the foregoing statement would not be too far off target. In 1985, Japanese investment in U.S. real estate narrowly reached the $1 billion mark. In 1986, however, that figure shot up to nearly $4 billion. At the end of 1987, the figure is estimated to have reached well over $6 billion, with a projected $9 to $10 billion right on its heels in 1988.

One of several reasons for this sudden surge of Japanese investment in recent years stems from a 1981 decision by the Japanese Ministry of Finance or (M.O.F.) to allow insurance companies to buy foreign real estate. The target group (not the decision itself) was the significant factor. This is evidenced by the M.O.F.'s decision to allow certain Japanese companies and private individuals to invest in foreign real estate back in the 1970s. The primary difference is the enormous financial strength of the insurance companies versus the individual company or private investor.

The M.O.F. is now investigating the possibility of allowing the giant Japanese pension funds to invest in U.S. property. That single act could release more than $180 billion in combined assets, with the U.S. as the primary target.

Another reason for the increase is more in the nature of a market-driven force. As alluded to before, this increase has been the interest rate levels in the U.S. and abroad. Because interest rates are higher in the U.S. than in Japan (and many other investor countries), the Japanese investor will obtain a relatively low interest loan in the mother country and then invest the funds in U.S. properties with leveraged yields. Thus, even a low yield from U.S. property will result in a higher return to the Japanese investor than if the funds were invested in the home country. This is because Japanese real estate equity investment yields are no more than 1 or 2 percentage points over the market interest rates charged. Similarly, funds borrowed in the U.S. would diminish the attractiveness of the U.S. real estate investment due to the higher interest rate charged on the loan and the resultant lower equity yield. The low-rate loan enables the Japanese investor to accept a lower yield from their U.S. investment than their U.S. counterpart could. Or, the Japanese can afford to pay more for the real estate than their U.S. counterparts due to the additional funds made accessible with this favorable financing.

The ability to pay more for an investment, also comes from the close relationship Japanese investor companies have had with the Japanese banks. Close historic ties have enabled the Japanese developers to commit to transactions for property they like almost on the spot. This time-saving, side-step is a cost-cutting measure that gives the Japanese developer the jump on its U.S. competitors when prime investment grade property comes on the market. And with the 8 to 9 percent mortgage rates available to them from their lead Japanese banks, they leave their American borrowing competitor—who borrows at a more conventional rate of 10 or 10.5 percent—far behind in terms of their borrowing options. The difference between a positive and negative cash flow on a building yielding a return of say, 7 percent, can be made on that slim difference in borrowing costs.

IN THE BEGINNING, GOD CREATED THE EARTH AND MAN. THEN MAN CREATED "REAL ESTATE," AND THEN THE JAPANESE BOUGHT IT.

One advantage relative to the Japanese strong cash flow tolerance (i.e., purchase bargaining position) that the American developers have is their experience with the typical American tenant. Unlike the Japanese tenants, who are forced to yield to landlord demands of several years rent in advance, the American tenants just balk at such demands when put to them by their Japanese landlords and simply leave, if necessary.

Location invasion

Similar to a military operation, the Japanese investors have been very location specific in their choice of cities. The large SMSAs (Standard Metropolitan Statistical Area), such as Los Angeles and New York, are slated as primary targets. In downtown Los Angeles, for example, almost one third of the buildings are owned by Japanese companies.

According to a recent Cushman Realty Corp. study, 6,513,756 square feet, or roughly 29 percent of the total downtown L.A. office space, is owned by Japanese corporations. The most notable Japanese-owned Los Angeles property is the Arco Plaza towers which sold for $620 million—cash. New York, the second major target of the Japanese, has relinquished ownership of a number of notable properties. Among these are the Tiffany & Co.'s Fifth Avenue building, (that sold for $945 per square foot, a record for U.S. retail space) the headquarters of ABC, Citicorp, Exxon and the famous Algonquin Hotel. Smaller SMSAs such as

TABLE 1

Foreign Direct Investment Position in the United States 1980-1985

All Dollars in Millions

	1980	1981	1982	1983	1984	1985
All Countries	$6,120	$8,889	$11,397	$13,946	$17,761	$18,557
Canada	1,158	1,770	1,882	2,106	2,844	2,580
Europe	2,254	3,675	5,035	6,638	8,255	8,821
European Communities (10)	2,119	3,450	4,651	6,224	7,714	8,238
Belgium	4	9	11	10	10	9
France	24	24	24	28	66	26
Germany	493	651	780	815	966	1,049
Italy	4	4	5	3	0	*
Luxembourg	23	28	29	25	0	24
Netherlands	999	1,507	1,742	2,189	2,471	2,325
United Kingdom	569	1,220	2,051	3,140	4,135	4,623
Denmark, Greece, and Ireland	2	7	11	12	42	*
Other Europe	135	225	384	414	541	583
Sweden	0	0	0	0	0	0
Switzerland	80	150	300	324	393	444
Other	56	75	84	90	148	139
Japan	264	302	394	457	744	1,054

* Unavailable

Source: Survey of Current Business, Oct. 1984, at 37–38, June 1985, at 32, Aug. 1985, at 52; U.S. Department of Commerce, News, June 25, 1986, at 6.

Washington D.C. and Boston are considered next. This has placed Washington D.C. in third place for the number of major office buildings owned by Japanese investors.

The Cushman study also indicated that the Japanese have a 36 percent investment in Hawaii, a 29 percent investment in California overall and a 23 percent investment on the East Coast, that includes approximately 6 percent in the Atlanta area.

Although well known for investing primarily in blue chip office buildings and developments, the ever increasing experience and sophistication of the Japanese investor company has now brought second-tier property and secondary market areas into view. This has included retail developments, apartments, certain industrial properties, and speculative property as well. Forays have been made into Chicago, Philadelphia, Indianapolis, Detroit and even Dallas.

This Japanese barge into blue chip property and now into second-tier property has displaced the domestic institutional investor. With the majority of prime first-tier property priced out of reasonable reach, and the slow but continuous encroachment into the second-tier market, the domestic investor has turned elsewhere. New investment strategies highlight retail and industrial properties, condominium development and apartment complexes. This, in turn, has had a positive effect on the values of suburban office parks. These high- risk suburban ventures with previously volatile value ranges, have stabilized. In addition, investment quality industrial property and retail developments have risen in value.

There may be tensions over trade issues between the U.S. and Japan, but joint ventures amongst American and Japanese investor companies have increased. More and more partnerships are being forged to establish real estate syndications. Japanese companies prefer alliances with U.S. firms for the obvious reason of familiarity. Zoning laws, building codes, labor relations and cultural nuances are handled more efficiently by the domestic end of the team.

Japanese insurance companies, for instance, are well known for their cautious stance on investment in real estate. This is due to the currency risk they have that requires them to pay out claims in yen. As a result of this risk averse position, they tend to link up with experienced U.S. developers and insurers.

FUTURE TRENDS FOR JAPANESE INVESTMENT IN U.S. REAL ESTATE CAN BE SUMMARIZED IN THE NUTSHELL TERM "DIVERSIFICATION."

American firms report that the Japanese, in turn, make excellent joint-venture partners. Not only do they materialize the developers dream of a deep pocket partner, but they are also patient, in for the long haul, and do not expect to reap an immediate fortune from their investment. Basically, they bring stability to the U.S. developers.

Japanese construction firms are also teaming up with U.S. partners. In 1982 U.S. developers using Japanese construction firms did $114 million in construction work. In 1986, that figure jumped to nearly $2 billion. Japanese construction firms, like Japanese developers, also have close ties to Japanese banks, allowing them to obtain low interest loans that American contractors cannot match.

Unfortunately, "all that glitters is not gold," and all U.S./Japanese partnerships do not necessarily work out. Western partners unfamiliar with the Japanese business culture many times assume that the ultimate goals of the partnership are the same for both parties. Due to the extremely competitive nature of the Japanese market, however, a Japanese partner eventually expects to become the dominant force in the partnership. Japanese firms which have attained foreign partnership privilege, have successfully overcome intense competition in their own country, and thus always expect to end up on top in the foreign arena as well.

When the Japanese partner structures its joint venture relationship as a "kogaisha" or child-company, the Japanese executives involved are on what could be termed a "sponge" mission. They are instructed to gather as much information, and obtain as much American know-how as possible, and then bring it back to the parent company for implementation. Thus, goals expressed or implied by the liaison managers are subservient to those of the mother company. All of this, of course, is usually not clear to the inexperienced American partner.

Because divestitures and acquisitions are almost nonexistent in Japan, the Japanese executive expends no energy or time trying to cope with the contingency. Instead, all energies are directed toward product perfection and ultimately toward market domination. Therefore, a clear understanding of the Japanese business culture and the ultimate goals of the Japanese partner are essential to developing a joint-venture entity which can stand on its own.

Contrary to what many Americans believe, the Japanese investor companies referred to thus far do not act as one homogeneous entity. They are as diverse as their American counterparts. If you study their corporate constraints and investment criteria, however, it is possible to place them into at least five investor group categories. These are: large insurance companies, developers, construction companies, real estate sales companies and individual investors. Within these five groups are identifiable segments of direct and indirect investors.

Direct investors have offices of their own in the United States or invest funds under their own name. Direct investors include trust banks, contractors, insurance companies and corporations. Indirect investors are those which invest funds for another party. Indirect investors include commercial banking concerns, real estate brokers and trust banks.

The largest of the five major groups are the insurance companies with more than $326 billion in combined assets. As mentioned previously, the insurance companies are super conservative, and in spite of their huge asset base have less than 1.5 percent of their investment portfolio in U.S. real estate. The insurance companies consider U.S. real estate as a partial hedge against inflation for their dollar-oriented paper securities. They also look for a 2 to 3 percent margin on their real estate investments above the U.S. Treasury bond yield.

The next Japanese investor group is the real estate developers. This extremely active group has managed to acquire more than 40 percent of all U.S. real estate purchased by the Japanese thus far. This materialized in part due to the financing advantages the developers have with their banks, as explained earlier. However, an even better advantage is their ability and willingness to venture into the construction end of the business. This is a "venture" only to the extent that the construction project is taking place in the U.S., assembling sites and erecting buildings are close to their entrepreneurial hearts.

The construction companies as a group are well known for their work where they have built condominium projects and resort hotels. They are now attempting to enter the market of the U.S. mainland. Because they also have strong ties with Japanese banks, U.S. developers are taking a closer look at the possible benefits such a give-and-take relationship might have. By lining up letters of credit, the Japanese construction companies circumvent the need to use their own cash until the development is complete. At this time the project cash flow or sale reversion is used to repay the construction loan, a simple yet enticing procedure that American construction companies strive for, yet rarely obtain.

Real estate sales companies are on the smaller end of the scale of investor companies. Similar to a firm like Coldwell Banker or Century 21, they deal primarily in residential investments and small-scale commercial properties. These companies perform an advisory function for their clients as well as play the role of intermediary. Due to the increased level of interest their clients have exhibited for purchasing U.S. real estate, some of the larger firms have listed U.S. properties in their portfolios. Because the companies in this investor group are smaller than the companies in the other investor groups, there is generally less red tape to wade through when an investment decision needs to be made. Thus, the element of speed becomes the primary advantage that the smaller firms hold over the large trading companies.

Finally, we come to the most diversified investor group identified—the individual investor. This group consists of high net worth individuals and successful midsize closely held businesses. Using the experience of the large corporations as trailblazers, the individual investor then follows on a relatively safe and explored path. Notably, Japanese tax law practically wipes out individual assets in excess of $3.6 million with inheritance taxes, so droves of wealthy individuals are investing in U.S. real estate.

The investor groups are segmented into direct and indirect investors. A

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brief description of direct investors is as follows:

- Trust banks can invest in the U.S. as they see fit, when acting as pension fund managers. They are involved in partial joint ventures, but prefer 100 percent equity investments.
- Contractors are also involved in 100 percent equity investments and partial equity deals. They make direct development investments by linking up with American developers on a joint-venture basis. Their effect on the market stems from initiating new developments.
- Insurance companies, like trust banks, are primarily involved in acquisitions with 100 percent equity positions. They are also involved in convertible mortgages. Japan has 23 life insurance companies; six or seven of these have real estate offices in the United States.
- Corporations are generally not well known in the United States due to their poor representation. Corporations have a broader investment perspective, but also prefer the 100 percent equity acquisitions. They deal in user-occupant clients and a few wealthy individuals.

There is often a fine line between direct and indirect investors. Several companies play both roles, depending on thier client needs and the government restrictions imposed for a particular type of activity. Indirect investors are as follows:

- Trust banks are one of the switch hitters playing both roles as required. Licensed by Japanese law as brokers, banks are the only major financial institutions so designated. They play a major role in equity investments by acquiring properties in the name of their clients.
- Commercial banks are limited by Japanese law concerning foreign real estate investment. They are not allowed to act in an advisory capacity nor collect referral fees. Their main market impact, then, involves structuring debt/equity deals for other investors.
- Real estate brokers have only a minor role as representatives for Japanese clients. Few have the authority for direct investment, and indirect investment comes in the form of commissions secured through developers.

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investment group, direct investors or indirect investors, all contribute to the aggregate cash infusion that is stabilizing the American commercial real estate market. Interestingly enough the total Japanese investment in U.S. real estate amounts to little more than one-half of 1 percent of the total $2.3 trillion value of all U.S. real property. Continued investment, favoring modification of Japanese law regarding foreign investments, will undoubtedly bolster all or most of the investor groups. Japan's large and affluent population will continue to demand more and more investment alternatives. Because Japanese investment in U.S. real estate is meant for the long haul, commitment to U.S. markets is relatively certain.

Regulations

One of the most attractive aspects of investing in U.S. real estate for foreign investors is the lack of restrictive regulations. Most U.S. laws concerning foreign real estate investments are directed toward disclosure rather than ownership constraints. By contrast, European and Japanese land use and property ownership laws are very limiting.

Three federal regulations govern the majority of reporting requirements for foreign owners of U.S. real estate. These are: *The Agricultural Foreign Investment Disclosure Act of 1978* (AFIDA), which requires all foreign owners to register all holdings in agricultural land. *The Foreign Investment in Real Property Tax Act* (FIRPTA), that requires purchasers of foreign-owned property to withhold 10 percent of the sale price to be turned over to the Internal Revenue Service. And finally, *The International Investment Survey Act of 1976* (IISA), that requires a disclosure to the U.S. Department of Commerce by each U.S. enterprise having a direct or indirect interest of more than 10 percent held in the company by a foreign person or investor.

In view of these relatively light U.S. regulatory laws and the rather restrictive land ownership and investment laws of other countries, the U.S. real estate market fares well for future foreign direct and indirect investment.

According to a recent Landauer Associates, Inc. report, Japanese institutional investors expressed concern about the future stability of the U.S.

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dollar. The Japanse investors also anticipate higher U.S. interest rates (that is presently materializing). The smaller Japanese investor groups, however, believe that the yen will stabilize and U.S. interest rates will fall to more acceptable levels in the very near future. With the increase in institutional uneasiness about the U.S. economy, diversification into real estate debt instruments and real estate investment in other countries may begin to rise.

A few years ago, Japanese investors were interested in only prime office buildings in select seaboard cities. Today office buildings are still the preferred investment target but no longer the exclusive target. Nor are the seaboard cities enjoying the monopoly they once had with Japanese money. Present investment trends are pointing to an even more diverse pattern of property types chosen for investment. Japanese airlines, developers and construction companies already in the hotel development sector are branching out into multifamily residential properties, resorts and even a few shopping centers.

Although greater familiarity with the U.S. real estate market has contributed to the expansion of Japanese money into second-tier markets, the simple law of supply and demand provides the greatest inputs. Top quality properties in preferred cities are limited. Competition for the best investment grade properties has increased and money supply pressures have increased. Investment into the 37 second-tier U.S. metropolitan areas will steadily increase with Chicago and Atlanta leading the way.

Convertible and participating mortgages will likely increase in popularity with U.S. developers as interest rates rise. This will then provide an expanded vehicle for investment into U.S. real estate by the large Japanese insurance companies. Banks and trust companies would also benefit from an increase in U.S. interest rates because they plan to substantially increase the pace of construction. However, construction companies themselves may be lured away from the American construction scene by the new government policies at home.

A Japanese government report adopted in 1987 recommends a significant investment in new Japanese infra-

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structure. This would include large public works programs such as dams, railways, roads and other major public projects. The Maekawa Commission Report also recommends programs for new and improved public housing projects and large-scale multifamily developments. The result of this could be a less aggressive marketing effort for new developments in the United States by the large Japanese construction companies. This in turn would draw away a great deal of capital previously slated for investment in the U.S.

Fortunately for the American real estate industry, the Japanese have been very successful in obtaining loan guarantees and permanent loans on office buildings and other large-scale projects. Due to their lower cost of funds and higher yield potential from U.S. developments, leaving the U.S. market entirely will not be on the top of their list.

Future trends for Japanese investment in U.S. real estate can be summarized in the nutshell term "diversification." All the investor groups will be scrutinizing investment opportunities on a much broader scale. Elements of location and property type will be linked to partnership structuring criteria, debt/equity participation and an accelerated pace of debt financing.

An interesting factor to consider, however, is the eventual tightening of the existing investment grade real estate market. In the midst of all the Japanese buying hoopla comes the possible doom of the resale market. The effective holding period for property owned by Japanese investors is not really known. What is known, however, is that Japanese corporations do not sell their property very easily. That is, a Japanese company that sells its interest in a major property holding may be perceived by the Japanese business community as having failed. This is unfathomable for most Japanese, so corporations almost never sell their buildings, in spite of significant potential profit. Therefore, new developments and acceptable second-tier properties may be the wave of the American real estate investor's future. **MB**

Victor Orth is a project manager specializing in complex real estate and tangible personal property appraisals.

The question of whether data processing costs should be distributed among various user groups is critical for both the data profession and the lending industry.

Data Processing Costs

The "experts" in management information systems say that distributing data processing costs is an excellent way to allocate scarce resources. Most of the available literature gives the impression that charge-back systems are already in use in most companies. We wanted to conduct a study of the savings and loans industry and see whether the management in this currently troubled industry are actually using charge-back systems.

Data processing (DP) departments have traditionally been accepted as necessary parts of organizations. Now, however, the issue of whether or not to distribute these costs across the various user groups is critical in both the data processing profession and in the business community.

Historically, the first DP functions were located within the accounting department. With increased usage of the DP function, a new department evolved.

We can define distributed data processing costs in terms of two steps. The first step is the estimation of the value of the services performed by the DP department for a user department. The second step is the actual transferring of these costs to that department.

In 1982 Olson & Ives described the reasons for wanting to allocate DP charges. These include allocating and regulating the demand for scarce resources, recovering costs (as an accounting policy), meeting legal/contractual requirements, providing data for planning, and the formal passing of the control of information system (IS) resources to users. Sommer later contended that a charge-back system encourages the experimentation and use of new technologies, and provides valuable information about resource utilization for planning and budgeting purposes.

Nolan claimed that "the initial effect of the charge-out system in communicating economic costs is negative in the sense of 'constraining' the use of computer-based systems." Cash points out that unallocated costs are viewed as an essentially free resource to the users, stimulating user requests and creating a climate conducive to encouraging experimentation. Charge-back procedures can also motivate both users and information technology facility managers to develop systems that meet real needs as Linder pointed out last year.

When information technology users are accountable through a charging system, their demands for services become more realistic, and the organization saves money on information costs (Linder, 1988). Accountable users employ resources more judiciously. Linder also contends that services that are expensive are easily misused. When services are free, or are treated as overhead, their use tends to increase to the maximum. When users are accountable, they make value judgments.

Cash also contends that often "the charge-out system for IS (DP) operations costs is based on a very complex formula." He contends that this leads to a situation where "the allocated cost center introduces a series of complexities and frictions."

Another argument often posed against the use of a charge-back system is related to the appropriateness of establishing an inside service department as a profit center. In some organizations, the DP department is allowed to charge out to end users more expense than they incur. This can happen, for example, when a standard cost system is used for charge-back and there are operating efficiencies that occur within the data processing department.

Depending on the method used to distribute the DP costs, even further benefits can accrue to the organization as a whole. In 1988 Bridges noted the need for the DP department to come to the aid of the newest crop of computer users. She suggests that, "The time has come for PC users to become more self-sufficient, and it's up to the information center (DP) staff to help them do it."

In addition to providing more support for the users, the DP department is responsible for the security and integrity of corporate data. Management is aware of the PCs' natural shortfalls in this area. This brings up the question of how to deal with DP's charge to maintain data security and still satisfy the user's needs. The problem for management information sys-

Ruth H. Bullard, Diane B. Walz, Roger Bomely and Dennis M. Bline tems (MIS) (DP) is one of control according to Herschel in 1987. Inefficiencies are more visible and can be corrected. Handling DP costs by a charge-back system provides management comparative information, that can be used to monitor and control PC usage.

The charging system establishes a way for managers to influence user behavior, for example separate rate structures for different service conditions. By placing a high price on one resource relative to another, discounts or varied billing rates for prime-shift versus non-prime-shift processing, demand is altered (Linder, 1988).

The last and perhaps the most important reason for establishing a charge-out system is to give management a tool for quality decision making. "If you're not measuring it, then you can't manage it." In order to determine whether an MIS function belongs under central control, users must know what the costs are. "Only then do they have a basis for comparing alternatives," said Bergstrom.

A charge-back system should promote the efficient and cost-effective use of information services by an organization (Emery,1986). An organization with an information technology charging system makes more informed decisions and exercises better management control (Linder, 1988).

Ground rules

The literature provides ground rules to follow in planning a distributed costing system. Many of the objections and negative attitudes toward a charge-back system can be eliminated by following one simple rule. It must be well designed and thought out by management prior to activating it. The successful charge-back system must have a clear set of objectives with demonstrated top management support (Bridges, 1988).

Charge-out systems should be perceived as being fair and reasonable on all sides (Cash, 1983). This would require that a system monitoring effectiveness begin at the same time as the charge-back system.

If the users work together with the DP department in developing the charge-back system, it can help avoid problems of fairness and can help make the system easier to understand. Charge-back systems can be too complex and unrealistic; as such they can drive a wedge between IS management and the user base. To avoid these problems, base the systems on an agreed upon standard cost/unit advised Cash in 1983. IS managers must define management objectives and bill users for output, such as for reports or transactions rather than for technically-oriented work units, such as CPU time or disk access (Bridges, 1988). An even better design is achieved by basing the charges upon items that are understandable to the users, such as so much per paycheck processed, or so much per order line (Sommer, 1988).

The accounting treatment for variances must also be considered. An IS operation charge-out system should separate IS efficiency-related issues from user utilization. After analysis, variances should be closed directly to corporate overhead. The real test of a charging system is whether it increases efficiency and effectiveness enough to justify the cost of administering it (Sommer, 1988).

There appears to be consensus that, in measuring and monitoring DP expenses from the user's perspective, the DP department must be a profit center rather than a cost or expense center.

There are perhaps as many different approaches to distributing data processing costs as there are corporate goals and individual personalities. One conclusion that can be drawn from all of the negative comments from end users against charge-back systems is that not all charge-back systems are equal or even equally effective. Perry (1988) provides perhaps the latest list of "musts" for instituting a charge-back system, embodied within the following steps:

- Develop a DP department budget.
- Decide which resources will be measured and costed.
- Estimate maximum and anticipated use levels for each resource.
- Decompose budget and allocate to cost pools.
- Calculate resource use rates.
- Select unit costing or resource method as basis for charging.
- Develop unit rates for applications using unit costing.

Many favor the approach put forth by Cash in 1983 to keep IS as an unallocated cost center but inform users through memos of what their development and operation charges would have been if a charge-out system was in place. Others say it is only a first step toward a "real" charge-back system. Bergstrom (1987) applauds memo billing because it is often a necessary first step toward measuring resources.

Once the decision to treat the DP department as a transfer cost (or cost-based) center has been made, then all that remains is to determine the basis for transferring costs. One such method is the cost-based method, which divides the projected MIS costs that are to be recovered by the projected resource usage to yield a unit price per resource.

There appears to be consensus that, in measuring and monitoring DP expenses from the user's perspective, the DP department must be a profit center rather than a cost or expense center. Advocates of this approach note that it puts the inside service on the same basis as outside and brings the pressures of the marketplace to bear. Consequently, it puts pressures on the IS function to hold costs down by stressing efficiency and to market itself more aggressively inside the company. To be a truly strategic resource, IS should be run as a business within a business, as a profit center with a flexible budget and a systematic way to price the services (Allen, 1987).

Market-based pricing has as its key concept the fact that MIS must be a low-cost producer/provider of affordable computing services—otherwise users should be free to buy elsewhere. It adopts an entrepreneurial stance, with rates that are competitive with the marketplace (Bergstrom, 1988).

This approach takes more commitment on the part of management. Market-based pricing mandates that computer facilities be not only competitive in price but also full service—in other words, run as a business enterprise, responsive to the requirements of the users and to the business priorities of the greater corporation

(Bergstrom, op cit). A refinement of the "full service" approach would fit better with smaller companies that are unable to afford the costs associated with such a large venture.

Under the "split-level" approach suggested by Linder, users are charged direct or full cost, depending on management's policies. The IS department is allocated revenue on a standard cost of services delivered, plus a standard fixed markup. Then the difference between the revenue of the IS department and the cost figure charged to users is closed to a corporate overhead account.

Regardless, if the market-based system or the split-level system is used, there are incentives for the DP department to improve the quality and quantity of their services, and management can get a better grasp on system usage.

There appears to be general agreement that DP departments should distribute their costs. Further, the literature surveyed seems to imply that DP costing systems are being used extensively.

To investigate the extent to which DP costing systems were being used, a questionnaire was developed for a detailed survey of distribution practices. For ease of comparison, the survey focused on one industry: United States Savings and Loans and the questionnaire was mailed to the 100 largest S&Ls in the United States.

The S&L industry was selected because it consists of regulated financial institutions that are currently experiencing economic setbacks. We think it is highly important to find out if this particular industry is using DP charge-back systems.

The premise of this article is that most S&Ls are not distributing DP costs. Also, we believe that the S&Ls that are distributing DP costs will be encountering substantial resistance from the user departments. While we agree that distributing DP costs is beneficial, we disagree with the inference that DP costing systems are being used extensively. We base these assumptions on our personal knowledge of the S&L industry and of charge-back systems in general.

In addition to the survey questions that dealt with an actual cost distribution system, the first five questions were used to help determine how much support the organization provided for its users. Question six determined the size of the data processing operation from a dollar standpoint, while seven through ten, determined if the surveyed companies did distribute data processing costs and the method used.

The survey was mailed with a cover letter and a stamped self-addressed envelope. As an inducement to responding to the survey, a summary was offered to participants if they would return an extra address label with their reply. One hundred surveys were mailed, one returned for an incorrect address and thirty-four responses were received. Seventy-one percent of the respondees requested a summary of the survey.

Survey results

The responses to the survey questions are presented in Tables 1, 2 and 3. The annual DP department budgets among the responding firms ranged from $300,000 to $25 million with an average of $7.2 million.

As expected most of the responding companies do utilize mainframe and microcomputers. Less than half use a service bureau/time-share type of system. Table 1 illustrates this.

A relatively small percentage of companies are currently using charge-back systems for DP costs. More than 71 percent never allocate DP costs. (See Table 2.)

However, it is surprising, and not in accordance with expectations, to learn that user resistance is actually a small percentage of the reasons offered for not allocating. One of the reasons mentioned, the system's inability to capture the information, was very surprising, especially because this response was given by companies averaging $7.2 million in annual DP costs.

Table 3 shows the methods used to allocate costs and again, the results are as expected; there are many methods used to allocate the costs. There apparently is no one method perceived as "the best." The system must be designed to meet the goals and needs of management in a particular company.

Based on the no responses, Table 4 shows that the lack of objections were from companies that used negotiated prices and/or actual costs incurred.

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This information will provide important guidance to DP managers in distributing DP costs in the future.

Many different management styles and many different goals must be satisfied in order to make any charge-back system workable. Nolan (1977) concluded that the effectiveness of any charge-back system stemmed from the educational level of the users and the degree of sophistication of the DP department.

The results of the questionnaire were as expected, except in respect to the lack of resistance from the end user. That is, 71 percent of the companies are not allocating DP costs. The primary reasons for not allocating

TABLE 1

Type of Equipment Ownership by Category

Type of Equipment	Response	Number	Percentage
Mainframe computers	yes	30	88%
Minicomputers	yes	29	85%
PCs	yes	34	100%
Local Area Networks	yes	29	85%
Service Bureau/Time Share	yes	15	44%

TABLE 2

Data on Distribution of DP Costs

Number of Departments allocating DP costs to end users:

Response	Number	Percent
Always	10	29%
Sometimes	13	38%
Never	11	33%

Reasons for "never" distributing DP costs included:

- Corporate policy (4)
- Users' inability to forecast (1)
- User resistance (1)
- System's inability to capture information (3)
- Getting ready to move to charge-back system (2)

TABLE 3

Methods Used to Allocate Costs

	Number	Percentage
Percent of hardware usage	10	29
Negotiated price	6	18
Actual costs incurred	15	44
Amount of time used	12	35
Fixed budgeted amount	6	18
Other	2	6

TABLE 4

End User Responses

Yes	11	32
Too new to know	2	6
No	10	29
	Number	Percentage
Charges not understood	11	32
Amounts net consistent	2	6
Amounts not fair	3	9

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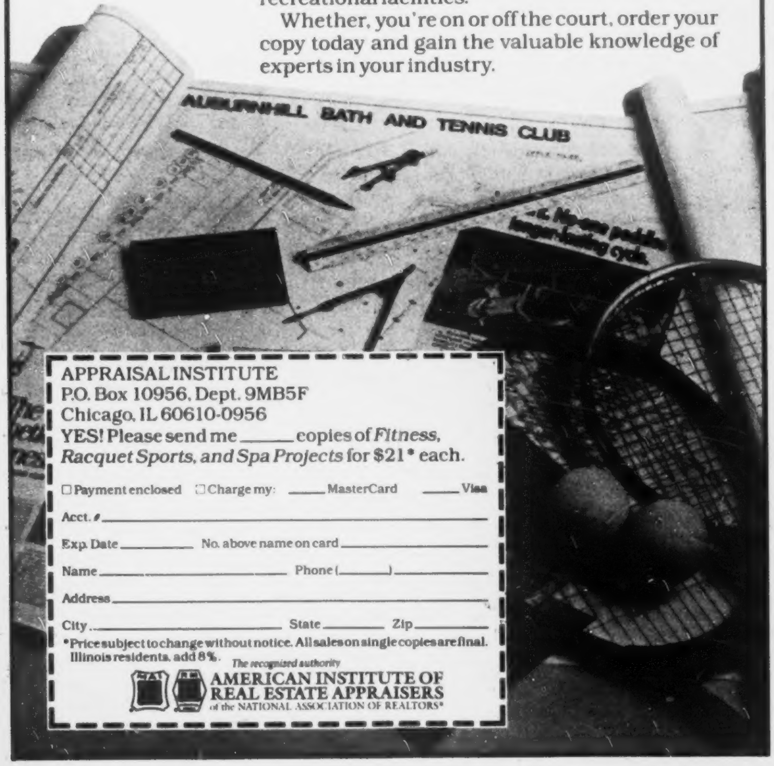

were corporate policy and the system's inability to capture information.

Certain factors must be considered in the design of any charge-back system. This is especially true given the current level of technology, where mainframes co-exist with desktop PCs, and where LANs are becoming commonplace.

Our recommendation is that the user should be exposed to a bidding process for needed services. This is basically the market price approach already explained. In this situation the DP department, and any outside service departments that the user may wish to invite to bid, submit a formal bid for the work to be performed. The bid is to be considered a firm, fixed, price quote.

This bid should be for whatever portion(s) of the total project the DP department wants to perform. The user will then take all the bids and select the one with the best price/performance ratio. If the vendor selected is an outside vendor, then a report should go back to the DP department indicating the price of the accepted bid. If the price is greater than the DP department bid then a reason for the selection needs to be given. The bidding procedure should enable the DP department to improve in those areas that need improvement.

If the user department wants to have access to the information that is available on the LAN, the departmental computer system, or the mainframe, they should be charged according to the rates established by the department managing that computer system. Again, this should involve the bidding process.

One of the problems that may arise is that the user department may select a computer system that is incompatible with the other system they would like to communicate with. That should be the option of the user who will ultimately bear the cost burden of that decision.

If management is looking at the departmental financial statements then the extra costs associated with DP expenses will be available. When information technology users are accountable through a charging system, their demands for services become more realistic. Thus, accountable users employ resources more judiciously. Any computer system beyond a desktop PC requires some DP staff for day-to-day needs. A mainframe needs operators and usually programmers. A LAN needs a supervisor who will set up new users, backup the data, and perform other necessary tasks. A departmental minicomputer will need someone to operate it.

Because these systems have fixed overhead expenses in the form of staffing and maintenance, when a user decides that they want to be connected to that resource, they must incur a portion of that overhead expense. Once again, it will help the user to decide whether what they hope to gain will be worth the price that they must pay. This connection cost will of necessity include not only the one-time "hook-up" costs for any necessary hardware and data processing personnel time, but will also include some portion of the DP departmental costs.

There must be a balance. When users do not think that what the DP department has to offer is worth what they are being charged, then they won't "buy" it from the DP department. On the other hand, if the user does not "purchase" the services of the DP department, then all of the costs will be retained rather than being distributed to the users. The balance must be established so that those who use the information pay a fair price. If it is not worth what the DP department is charging, then management should be concerned that DP costs are too high.

If the variance is favorable in the DP department's financial budgets, then the users and the company are getting more than their money's worth. If the variance is unfavorable, then the data processing department is costing more than what it should.

In the S&L industry distribution of DP costs would help management to better manage and allocate scarce resources. **MB**

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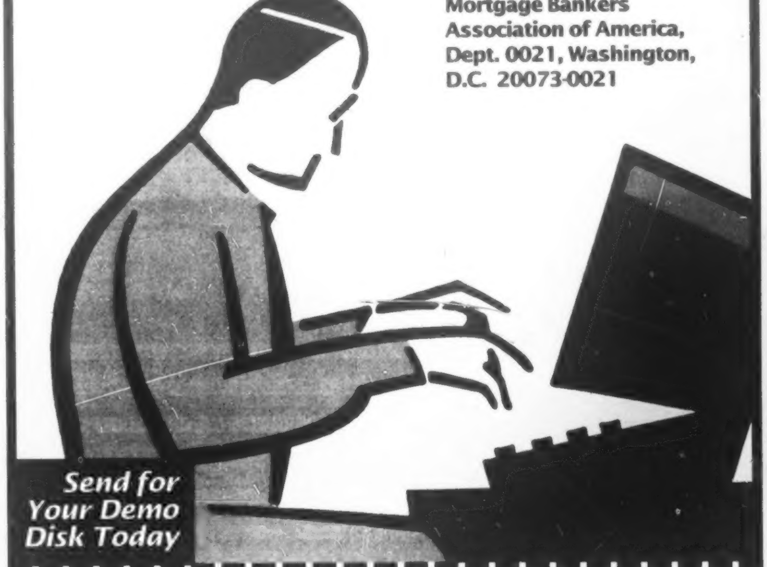

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VITAL STATISTICS

INTEREST RATES & YIELDS
1- TO 4-FAMILY MORTGAGES

	FHA OPINION SURVEY	FHLBB			FNMA		FHLMC	
1988	FHA New Homes[1]	CONVENTIONAL[2] FRM	CONVENTIONAL[2] ARM	Median Cost of Funds FSLIC Institutions	1-Yr. ARM	FRM Conv.	ARMs	FRMs
NOV	10.43%	10.54%	8.76%	7.35%	8.91%	10.18%	8.16%	10.27%
DEC	10.72	10.53	8.78	7.40	9.39	10.55	8.40	10.61
JAN 1989	10.75	10.60	8.80	7.52	9.48	10.59	8.55	10.73
FEB	10.79	10.80	9.07	NA	9.64	10.65	8.65	10.65
MAR	**NA**	**10.84**	**9.26**	**NA**	**10.07**	**11.09**	**9.09**	**11.03**

SELECTED SECURITIES

			U.S. GOVERNMENT				
1988	FEDERAL FUNDS RATE	PRIME COMMERCIAL PAPER (3-Month)	6-Month	1-Year	3-Year	10-Year	A-Rated Utility
NOV	8.35%	8.66%	7.86%	8.48%	8.72%	8.96%	10.12%
DEC	8.76	9.11	8.22	8.99	9.11	9.11	10.08
JAN 1989	9.12	9.04	8.36	9.05	9.20	9.09	10.09
FEB	9.36	9.37	8.55	9.25	9.32	9.17	10.25
MAR	**9.85**	**9.95**	**8.85**	**9.57**	**9.61**	**9.36**	**10.37**

CURRENT SECONDARY MARKET YIELDS

SPREADS
(Basis Points)

1988	GNMA[3]	FNMA[3]	FHLMC[3]	GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
DEC	10.26%	10.24%	10.22%	115	113	111
JAN 1989	10.34	10.30	10.30	125	121	121
FEB	10.37	10.33	10.33	120	116	116
MAR	**10.63**	**10.58**	**10.57**	**127**	**122**	**121**

SECONDARY MARKET ACTIVITY
(Dollars in Millions)

	FNMA				FHLMC				GNMA	
	Portfolio		Mortgage-Backed Securities						Pass-Through Securities	
1988	Commitments	Purchases	Out-Standing	Issued	Commitments To Sell	Commitments To Buy	Mortgages Purchased	Mortgages Sold	Applications	Issued
NOV	$1,289	$1,596	$174,278	$5,405	$3,759	$7,156	$4,109	$4,231	$6,380	$3,886
DEC	1,350	1,726	178,250	5,434	5,888	10,101	5,842	5,511	3,719	4,856
JAN 1989	1,087	1,037	180,822	4,074	3,492	5,206	3,586	3,408	4,830	4,584
FEB	**3,557**	**905**	**184,209**	**4,811**	**6,360**	**8,411**	**5,088**	**4,900**	**2,000**	**3,990**
1988 TOTAL	23,435	23,110	---	54,878	41,271	70,669	44,075	39,777	58,579	56,532
1987 TOTAL	25,415	20,531	---	63,230	68,210	76,615	76,840	75,018	116,611	96,983
2 MONTH AVG.[4] 1989	2,322	971	---	4,443	3,180	4,206	2,544	2,450	3,415	4,287
1988	2,385	1,948	---	2,436	1,983	4,389	2,731	2,123	2,673	3,745
1987	930	1,162	---	5,527	8,129	7,997	7,956	8,030	12,800	9,986

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES

(Units in Thousands, Seasonally Adjusted Annual Rates)

	BY TYPE OF UNIT						BY REGION							
	HOUSING STARTS			BUILDING PERMITS			HOUSING STARTS				BUILDING PERMITS			
1988	**Total**	**1-4 Units**	**5+ Units**	**Total**	**1-4 Units**	**5+ Units**	**Northeast**	**Midwest**	**South**	**West**	**Northeast**	**Midwest**	**South**	**West**
NOV	1,567	1,206	361	1,516	1,129	387	219	275	613	460	205	245	573	493
DEC	1,577	1,206	371	1,566	1,162	404	201	343	609	424	207	357	566	436
1989 JAN	1,690	1,269	421	1,507	1,140	367	296	321	635	438	227	293	573	414
FEB	**1,498**	**1,108**	**390**	**1,404**	**1,079**	**325**	**229**	**277**	**592**	**400**	**209**	**302**	**523**	**370**
1988 TOTAL	1,488	1,140	348	1,463	1,083	380	235	274	575	404	234	269	548	413
1987 TOTAL	1,621	1,212	409	1,535	1,114	421	269	298	634	420	272	282	575	406
2 MONTH AVG. (SAAR) 1989	1,594	1,189	406	1,456	1,110	346	263	299	614	419	218	298	548	392
1988	1,451	1,113	338	1,339	1,033	306	315	240	527	370	261	246	487	345
1987	1,814	1,346	468	1,690	1,250	441	305	401	639	470	300	368	580	443

HOME SALES

(Units in Thousands)

	EXISTING HOMES			NEW HOMES		
1988	**Sold (SAAR)**	**Available for Sale**	**Months Supply At Current Sales Rate**	**Sold (SAAR)**	**Available for Sale**	**Months Supply At Current Sales Rate**
NOV	3,710	2,600	8.5	650	364	6.9
DEC	3,920	2,160	6.5	674	366	6.7
1989 JAN	3,550	2,400	8.1	691	369	6.5
FEB	**3,440**	**2,570**	**9.0**	**626**	**374**	**7.5**
1988 TOTAL	3,594	---	---	676	---	---
1987 TOTAL	3,526	---	---	671	---	---
2 MONTH AVG. (SAAR) 1989	3,495	---	---	659	---	---
1988	3,210	---	---	616	---	---
1987	3,615	---	---	729	---	---

VALUE OF NEW PRIVATE CONSTRUCTION PUT IN PLACE

(Units in Billions of 1982 Dollars, Seasonally Adjusted Annual Rates)

Total[5]	**1–Unit**	**2+ Units**	**Nonresidential**
$286.2	$106.3	$19.0	$77.2
288.6	107.5	18.9	78.4
293.5	108.0	19.7	81.4
292.8	**107.8**	**20.8**	**81.0**
281.8	103.5	19.3	77.9
283.0	100.7	22.4	78.2
293.2	107.9	20.3	81.2
278.3	102.5	20.5	76.4
282.3	98.8	25.2	76.4

LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED
By Type of Institution and By Type of Unit

(Dollars in Millions)

1988	1-4 UNITS					5+ UNITS					NONRESIDENTIAL				
	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies
SEP	$36,328	$8,690	$18,176	$8,737	$342	$3,405	$259	$1,933	$550	$351	$10,585	$117	$1,938	$6,263	$2,131
OCT	30,578	6,273	16,053	7,586	332	2,707	327	1,559	344	247	15,669	84	2,037	10,501	2,936
NOV	28,138	5,430	14,704	7,314	352	3,406	600	1,605	659	271	11,252	23	1,496	6,546	3,090
DEC	**32,004**	**6,459**	**16,502**	**8,356**	**314**	**4,507**	**404**	**2,450**	**874**	**449**	**20,183**	**224**	**2,389**	**11,859**	**5,607**
1988 TOTAL	374,401	85,307	186,237	95,474	3,190	37,876	4,526	20,379	6,988	3,553	175,754	1,032	22,953	119,942	29,714
1987 TOTAL	449,544	110,093	208,054	124,551	3,209	44,981	2,409	22,492	8,299	3,547	168,652	2,871	25,613	110,490	28,160
12 MONTH AVG. 1988	31,200	7,109	15,520	7,956	266	3,156	377	1,461	582	296	14,646	86	1,913	9,995	2,476
1987	37,462	9,174	17,338	10,379	267	3,748	201	1,874	692	296	14,054	239	2,134	9,208	2,347
1986	37,921	10,969	17,265	9,051	318	4,156	598	1,897	598	310	12,281	340	2,276	6,994	2,492

MORTGAGE INSURANCE

(Units in Thousands, Dollars in Millions)

1988	APPLICATIONS RECEIVED (Units)				LOANS INSURED							
	TOTAL	FHA[8]	VA	PRIVATE	TOTAL		FHA		VA		PRIVATE	
					Units	Amount	Units	Amount	Units	Amount	Units	Amount
NOV	126	69	17	40	92	$7,007	41	$2,536	18	$1,334	33	$3,137
DEC	116	58	18	40	106	7,852	57	3,502	18	1,368	31	2,982
1989 JAN	106	59	16	31	121	8,656	76	4,629	17	1,240	28	2,787
FEB	**114**	**68**	**15**	**31**	**93**	**6,815**	**56**	**3,509**	**16**	**1,221**	**21**	**2,085**
1988 TOTAL	1,755	949	211	595	1,334	98,012	699	42,577	211	15,771	424	39,664
1987 TOTAL	2,340	1,211	408	721	2,282	159,668	1,320	81,881	451	33,312	511	44,475
2 MONTH AVG. 1989	110	64	16	31	108	7,737	66	4,069	17	1,231	25	2,436
1988	125	71	16	38	111	7,758	65	3,902	18	1,323	28	2,533
1987	226	136	41	49	173	11,908	94	5,737	41	2,985	38	3,186

NA—Not Available; SAAR—Seasonally Adjusted Annual Rate

[1] Secondary market gross yields. Numbers shown for each month are the average of yields from the first day of the month shown and the first day of the subsequent month.

[2] Effective rate on loans closed.

[3] Securities for 0 to 30 day delivery.

[4] Average covers one month less for FHLMC.

[5] In addition to the categories of private construction shown, the total also includes these categories: residential improvements, railroads, electric light and power, gas, telephone and telegraph, petroleum pipelines, and farm nonresidential.

[6] In addition to the categories shown, the total also includes private pension funds, private MBS conduits, state and local retirement funds, Federal credit agencies, mortgage pools, and state and local investment agencies.

[7] Savings & Loans and Mutual Savings Banks.

[8] FHA applications received includes the Direct Endorsement Program.

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JUNE 1989

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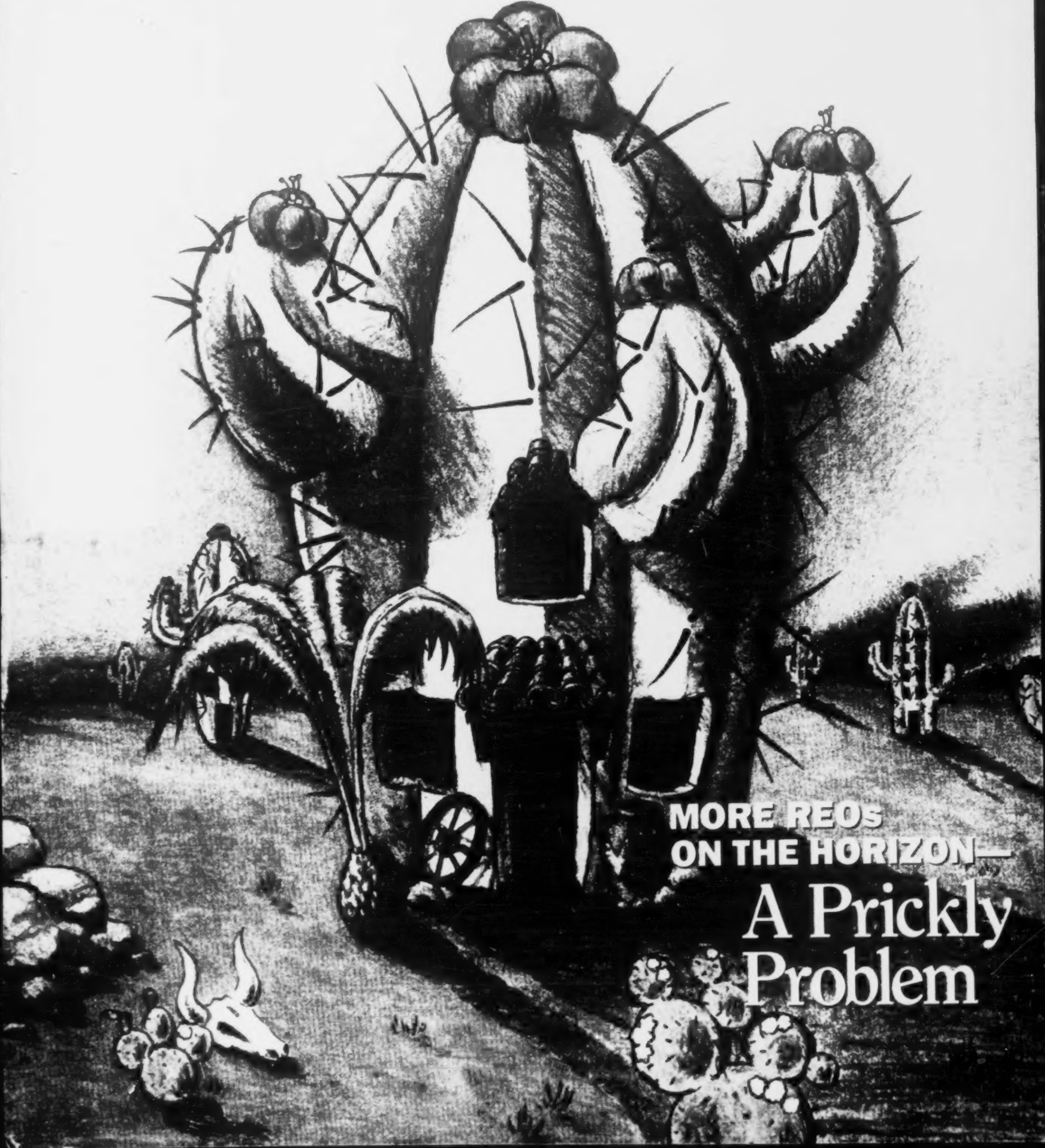

MORE REOs ON THE HORIZON—

A Prickly Problem

CONTENTS

JUNE 1989 VOLUME 49 NUMBER 9

COVER: Servicing

Lenders in the Southwest should brace for a whole new crop of REOs. Government efforts to shut down insolvent thrifts could spring a new supply of foreclosed properties on already soft markets like Phoenix. The likelihood that this will further weaken property values is just one more thorny issue servicers must contend with in this year of major change.

16 Southwestern REOs: A Thorny Problem *A possible domino effect could result from any large-scale liquidation of REOs held by thrifts being closed by the government. A firesale of Southwestern REOs could further erode property values and drive marginally solvent thrifts under.* By RON BARBIERI AND STEVE RANDALL

26 Servicing—A Risky Line Item *With servicing finding its way onto the balance sheet increasingly, ways to hedge this shifty line item become important.* By HAL HINKLE AND BILL GRATHWOHL

38 Servicing Risk: Managing Uncertainties *Spotting potential default risk early is the hallmark of superior servicing managers. Knowing where to find the red flags that signal trouble ahead is key.* By HUNTER WOLCOTT

49 Talking Servicing With Lomas' Glasgow *Many servicing executives have been waging an all-out war on costs in the wake of 1987's bleak performance. Bill Glasgow talks about what his company and others have done to turn things around.* By JANET REILLEY HEWITT

Internal Management

56 Life Was Simpler Then *Mortgage pricing decisions used to be easy when product choices did not read like a menu at a Chinese restaurant. Here's some how-to's for a more complicated world.* By JOHN W. BALLANTINE, JR.

67 Rethinking Originations *Shorter processing time will be essential in the 1990s. The whole origination process needs rethinking to find the key to fast loan approvals.* By GREGORY P. HACKETT

77 Prevailing Winds: Laboring with Less *Mortgage executives should staff origination jobs with appropriately skilled employees. Using high-priced staff for low-skilled jobs is a costly management mistake.* By RICHARD E. WILKES

Secondary Market

81 The Search for a Better Mortgage Hedge *The Chicago Board of Trade is launching new contracts this month to help mortgage lenders hedge. Backers of the new contracts hope this third attempt to design a workable mortgage hedge will be the charm.* By RALPH D. VERMILIO

Executive Essay

87 Loan Quality is Job One *Why do some lenders still compromise what most concede is the basic principle of successful mortgage banking?* By JAMES R. CARROLL, CMB

DEPARTMENTS

9 LETTERS
11 BUSINESS ALERT
13 BOARDROOM VIEW
90 PEOPLE
98 THE SECONDARY MARKET
95 ECONOMIC TRENDS
99 INDEX TO ADVERTISERS

COVER ILLUSTRATION BY LINA CHESAK

PORTFOLIO

REOs on the Southwestern Horizon

Like the cactus, with its formidable thorns and beautiful flowers, the thought of more REOs sprouting up in the Southwestern landscape has both good aspects and bad.

But for lenders trying to put the brakes on declining property values to preserve the value of REO portfolios, the thought of more foreclosed properties being dumped on the market has mostly bad aspects. Granted, the regulators are dealing with a thorny problem here. These institutions will end up costing the federal government and taxpayers more money with every passing day that these necessary liquidations are put off. But the key question is whether the regulators will be seeding the ground for a whole new crop of thrift failures by flooding the market all at once with still more REOs, thus sending prices still further southward.

But for long-term investors in both residential and commercial properties, there are value investments galore in Arizona and Texas real estate. The federal regulators closing down failed thrifts will almost certainly increase the buying opportunities there for investors. When the dust settles, buyers are likely to pick up good values for any type of property under the sun.

This month's cover story will not resolve any of the REO policy questions tied to the insolvent thrift closings. But the article should be of interest to servicers with REOs and delinquent loans in Arizona and Texas. Other servicing topics covered in this issue are: ways to hedge servicing assets that wind up on the balance sheet; servicing risk management techniques and clues to spotting potential default risks; and an interview with the head of servicing at Lomas.

Other hot topics covered in the June issue are: mortgage pricing and how to price in a financially informed way; a blueprint for re-examining originations with an eye toward short-circuiting delays in loan approvals; a program for dividing the labor in loan production to avoid misusing high-priced loan officers; and a piece on the debut of some new mortgage futures contracts at the CBOT.

Janet Reilley Hewitt
Editor

COMING IN JULY

What's the Big Deal?

Standard & Poor's rating expert will size up how big the deals have gotten in the gradually growing market for commercial mortgage securities. How large has that market become and can it live up to its early promise? Next month's offerings will also include a piece forecasting job growth and population migration among the nation's metro markets—who's on the map and who's off in terms of future demand for office and retail space.

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THE MAGAZINE OF REAL ESTATE FINANCE

VOLUME 49 NUMBER 9

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VITAL STATISTICS

INTEREST RATES & YIELDS

1- TO 4-FAMILY MORTGAGES

	FHA OPINION SURVEY	FHLBB			FNMA		FHLMC	
1989	FHA New Homes[1]	CONVENTIONAL[2] FRM	ARM	Median Cost of Funds FSLIC Institutions	1-Yr. ARM	FRM Conv.	ARMs	FRMs
JAN	10.75%	10.60%	8.80%	7.52%	9.48%	10.59%	8.55%	10.73%
FEB	10.79	10.80	9.07	NA	9.64	10.65	8.65	10.65
MAR	11.02	10.83	9.24	NA	10.07	11.09	9.09	11.03
APR	**NA**	**10.93**	**9.45**	**NA**	**9.80**	**10.94**	**9.40**	**11.05**

SELECTED SECURITIES

1989	FEDERAL FUNDS RATE	PRIME COMMERCIAL PAPER (3-Month)	U.S. GOVERNMENT 6-Month	1-Year	3-Year	10-Year	A-Rated Utility
JAN	9.12%	9.04%	8.36%	9.05%	9.20%	9.09%	10.09%
FEB	9.36	9.37	8.55	9.25	9.32	9.17	10.25
MAR	9.85	9.95	8.85	9.57	9.61	9.36	10.37
APR	**9.84**	**9.81**	**8.65**	**9.36**	**9.40**	**9.18**	**10.33**

CURRENT SECONDARY MARKET YIELDS

SPREADS

(Basis Points)

1989	GNMA[3]	FNMA[3]	FHLMC[3]	GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
JAN	10.34%	10.30%	10.30%	125	121	121
FEB	10.37	10.33	10.33	120	116	116
MAR	10.63	10.58	10.57	127	122	121
APR	**10.58**	**10.55**	**10.54**	**140**	**137**	**136**

SECONDARY MARKET ACTIVITY

(Dollars in Millions)

	FNMA				FHLMC				GNMA	
	Portfolio		Mortgage-Backed Securities						Pass-Through Securities	
1988	Commitments	Purchases	Out-Standing	Issued	Commitments To Sell	Commitments To Buy	Mortgages Purchased	Mortgages Sold	Applications	Issued
DEC	$1,350	$1,726	$178,250	$5,434	$5,888	$10,101	$5,842	$5,511	$3,719	$4,856
JAN 1989	1,087	1,037	180,822	4,074	3,492	5,206	3,586	3,408	4,830	4,584
FEB	3,557	905	184,209	4,811	6,360	8,411	5,088	4,900	2,000	3,990
MAR	**1,771**	**1,469**	**188,071**	**5,473**	**NA**	**NA**	**NA**	**NA**	**5,620**	**3,902**
1988 TOTAL	23,435	23,110	---	54,878	41,271	70,669	44,075	39,777	58,579	56,532
1987 TOTAL	25,415	20,531	---	63,230	68,210	76,615	76,840	75,018	116,611	96,983
3 MONTH AVG.[4] 1989	2,138	1,137	---	4,786	4,926	6,809	4,337	4,154	4,150	4,159
1988	2,864	2,224	---	2,742	2,174	4,142	2,731	2,123	2,934	3,532
1987	1,555	1,253	---	5,227	8,129	7,997	7,956	8,030	12,158	10,178

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES

(Units in Thousands, Seasonally Adjusted Annual Rates)

	BY TYPE OF UNIT						BY REGION							
	HOUSING STARTS			BUILDING PERMITS			HOUSING STARTS				BUILDING PERMITS			
1988	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units	Northeast	Midwest	South	West	Northeast	Midwest	South	West
DEC	1,577	1,206	371	1,566	1,162	404	201	343	609	424	207	357	566	436
JAN 1989	1,678	1,265	413	1,507	1,140	367	293	313	642	430	227	293	573	414
FEB	1,476	1,090	386	1,415	1,084	331	226	278	573	399	205	300	521	389
MAR	**1,397**	**1,042**	**355**	**1,221**	**940**	**281**	**149**	**307**	**546**	**395**	**180**	**243**	**448**	**350**
1988 TOTAL	1,488	1,140	348	1,463	1,083	380	235	274	575	404	234	269	548	413
1987 TOTAL	1,621	1,212	409	1,535	1,114	421	269	298	634	420	272	282	575	406
3 MONTH AVG. (SAAR)														
1989	1,517	1,132	385	1,381	1,056	326	223	299	587	408	204	279	514	384
1988	1,477	1,153	324	1,384	1,059	326	301	249	543	384	276	256	500	353
1987	1,779	1,325	454	1,687	1,239	448	307	378	624	469	305	349	592	441

HOME SALES

(Units in Thousands)

	EXISTING HOMES			NEW HOMES		
1988	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate
DEC	3,920	2,160	6.5	674	366	6.7
JAN 1989	3,550	2,400	8.1	694	370	6.5
FEB	3,480	2,450	8.5	621	375	7.6
MAR	**3,330**	**2,510**	**9.1**	**587**	**376**	**7.8**
1988 TOTAL	3,594	---	---	676	---	---
1987 TOTAL	3,526	---	---	671	---	---
3 MONTH AVG. (SAAR)						
1989	3,453	---	---	634	---	---
1988	3,250	---	---	630	---	---
1987	3,640	---	---	726	---	---

VALUE OF NEW PRIVATE CONSTRUCTION PUT IN PLACE

(Units in Billions of 1982 Dollars, Seasonally Adjusted Annual Rates)

Total[5]	1-Unit	2+ Units	Nonresidential
$288.6	$107.5	$18.9	$78.4
290.0	108.1	19.6	81.6
286.8	107.2	20.3	81.1
291.7	**105.2**	**20.4**	**84.3**
281.8	103.5	19.3	77.9
283.0	100.7	22.4	78.2
289.5	106.8	20.1	82.3
279.1	102.7	20.0	77.1
281.8	99.0	24.7	76.1

LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED
By Type of Institution and By Type of Unit

(Dollars in Millions)

	1-4 UNITS					5+ UNITS					NONRESIDENTIAL				
1988	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies
OCT	$30,578	$6,273	$16,053	$7,586	$332	$2,707	$327	$1,559	$344	$247	$15,669	$84	$2,037	$10,501	$2,936
NOV	28,138	5,430	14,704	7,314	352	3,406	600	1,605	659	271	11,252	23	1,496	6,546	3,090
DEC	32,145	6,459	16,502	8,356	455	4,686	404	2,450	874	628	20,455	224	2,389	11,859	5,879
1989 **JAN**	**25,935**	**5,286**	**12,352**	**7,754**	**197**	**2,898**	**561**	**1,433**	**396**	**253**	**11,576**	**121**	**1,604**	**7,598**	**2,189**
1988 TOTAL	374,401	85,307	186,237	95,474	3,190	37,876	4,526	20,379	6,988	3,553	175,754	1,032	22,953	119,942	29,714
1987 TOTAL	449,544	110,093	208,054	124,551	3,209	44,981	2,409	22,492	8,299	3,547	168,652	2,871	25,613	110,490	28,160
1 MONTH AVG. 1989	25,935	5,286	12,352	7,754	197	2,898	561	1,433	396	253	11,576	121	1,604	7,598	2,189
1988	21,452	5,742	9,672	5,693	32	2,269	160	1,449	432	81	13,803	17	1,593	10,609	1,473
1987	33,359	8,791	13,193	1,902	221	3,779	529	1,576	658	132	8,999	428	1,569	5,764	1,174

MORTGAGE INSURANCE

(Units in Thousands, Dollars in Millions)

	APPLICATIONS RECEIVED (Units)				LOANS INSURED							
	TOTAL	FHA[8]	VA	PRIVATE	TOTAL		FHA		VA		PRIVATE	
					Units	Amount	Units	Amount	Units	Amount	Units	Amount
1988 DEC	116	58	18	40	106	$7,852	57	$3,502	18	$1,368	31	$2,982
1989 JAN	107	60	16	31	121	8,656	76	4,629	17	1,240	28	2,787
FEB	114	68	15	31	93	6,817	56	3,509	16	1,223	21	2,085
MAR	**147**	**86**	**16**	**45**	**95**	**7,142**	**51**	**3,189**	**18**	**1,364**	**26**	**2,589**
1988 TOTAL	1,755	949	211	595	1,334	98,012	699	42,577	211	15,771	424	39,664
1987 TOTAL	2,340	1,211	408	721	2,282	159,668	1,320	81,881	451	33,312	511	44,475
3 MONTH AVG. 1989	123	71	16	36	103	7,739	61	3,776	17	1,276	25	2,487
1988	140	83	15	42	106	7,517	59	3,577	18	1,342	29	2,598
1987	253	154	44	55	197	13,598	112	6,898	47	3,463	38	3,237

NA—Not Available; SAAR—Seasonally Adjusted Annual Rate

[1] Secondary market gross yields. Numbers shown for each month are the average of yields from the first day of the month shown and the first day of the subsequent month.

[2] Effective rate on loans closed.

[3] Securities for 0 to 30 day delivery.

[4] Average covers one month less for FHLMC.

[5] In addition to the categories of private construction shown, the total also includes these categories: residential improvements, railroads, electric light and power, gas, telephone and telegraph, petroleum pipelines, and farm nonresidential.

[6] In addition to the categories shown, the total also includes private pension funds, private MBS conduits, state and local retirement funds, Federal credit agencies, mortgage pools, and state and local investment agencies.

[7] Savings & Loans and Mutual Savings Banks.

[8] FHA applications received includes the Direct Endorsement Program.

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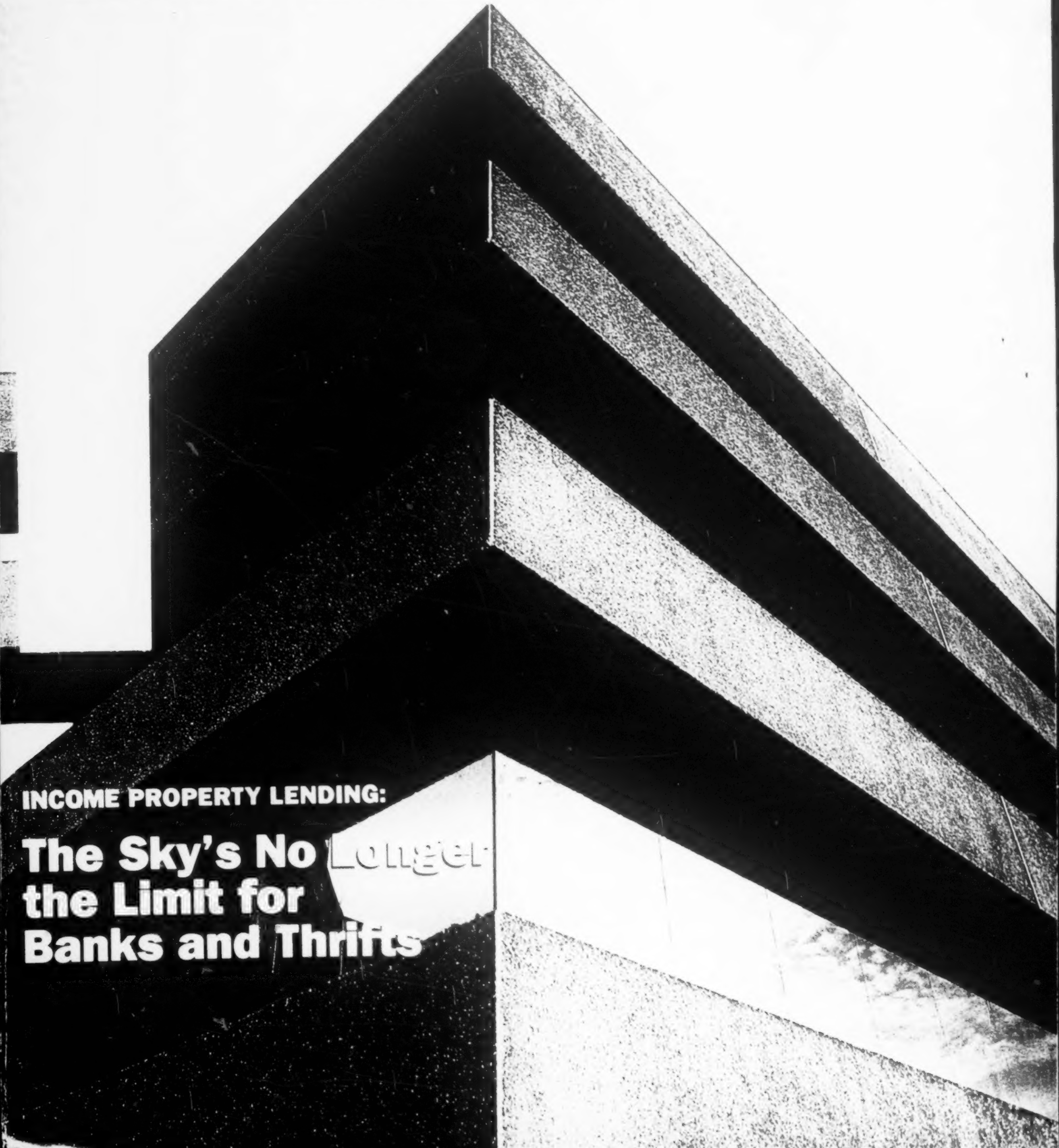

INCOME PROPERTY LENDING:

The Sky's No Longer the Limit for Banks and Thrifts

CONTENTS

JULY 1989 VOLUME 49 NUMBER 10

COVER: INCOME PROPERTY

For banks and thrifts, the sky will no longer be the limit when it comes to income property lending. Strict new risk-based capital rules for both banks and thrifts and the thrift bailout legislation will set new limits on the amount of lending that institutions can do for multifamily housing, office building construction or even residential construction projects. As a result, it will be costlier for banks and thrifts to commit to a business plan that is heavily weighted toward income property lending. For thinly capitalized institutions, the sun is indeed setting on the days of income property empire building.

14 Income Property's Brave New World *Tough new risk-based capital rules are being finalized by federal regulators of banks and thrifts. The income property lending market may never be the same.* By MICHAEL L. RYAN

19 The Job Growth Barometer *There is a new group of metro markets emerging as job growth hot spots. Houston and Oklahoma City may have turned the corner, according to this research.* By ROBERT E. HOPKINS

28 Demographics: How to Choose, Use and Not Abuse Them *A basic primer on the facts lenders need to know about people, places and cities and where to find this data.* By CHRIS MORONE

32 Growing the Market for Commercial MBS *The conditions are not yet ripe for the fledgling income property securitization market to come of age.* By JOSEPH FRANZETTI

43 Commercial MBS: The Case for New Legislation *These authors argue that some legal groundwork needs to be laid before the commercial MBS market can reach its potential.*
By LOUIS H. NEVINS AND FRANCIS X. SULGER

49 Appraising the Income Property Appraisal *A practitioner walks lenders through some of the finer points of the modern income property appraisal.* By ROBERT F. ROYCE

57 Hotel Trouble *Some S&Ls found out the hard way that hotel and resort lending can be one way to get burned.* By JERRY MORRISON

63 Superfund Suits: Minimizing Exposure *What lenders need to know about toxic waste cleanup liability and some legal safe havens to avoid being hit with cleanup costs.* By L. STEPHEN PASTOR

Essay

71 The Coinsurance Programs *The missteps of some coinsurance lenders do not justify reforms that would kill these programs.* By GAYE G. BEASLEY

DEPARTMENTS

9 BUSINESS ALERT
11 BOARDROOM VIEW
80 PEOPLE
81 THE SECONDARY MARKET
83 ECONOMIC TRENDS
87 INDEX TO ADVERTISERS

PHOTOGRAPHY BY MICHAEL MELFORD/THE IMAGE BANK

PORTFOLIO

Income Property—A Changed Perspective

The sky is not exactly falling on regulated financial institutions. But the perception that deregulation left the lending landscape a little too wide open has prompted a perhaps similarly earthshaking event—an agreement by an international group of financial institution regulators. What's more, these regulators from 12 leading industrialized nations agreed upon something of great market significance that is actually coming to pass in the near future.

The international plan produced last year is widely referred to as the Basle Agreement. It grew out of an attempt to set regulatory capital requirements that account for the varying risks of the broad range of assets that banks and thrifts can now hold. Income property and multifamily housing loans ended up in the 100 percent risk category, along with third-world debt. Home loans and agency MBSs wound up in much less risky categories—thus requiring considerably less capital. It doesn't require much reflection to see that a shift away from commercial property lending by these institutions is likely, in favor of the more favored asset types. Banks and thrifts also are expected to price income property loans higher to make the return worth tying up more of their capital.

The risk-based capital rules by themselves signal a major shakeup in income property finance, which the cover story explores. But there are other international economic factors at work in this marketplace. The changing relative value of the dollar is a force now dictating market demand for income property financing. The industrial Midwest has been rebounding on the coattails of international demand for U.S. goods. That and other factors have caused major job growth centers in the U.S. to shift away from the hot coastal metro markets of the mid-1980s to the heartland cities and places like Houston, according to a Salomon Brothers researcher.

This issue is devoted exclusively to income property finance—long overdue recognition for yet another aspect of mortgage finance in the midst of pivotal change.

Janet Reilley Hewitt
Editor

COMING IN AUGUST

Credibility Problem for Credit Reports

The next issue will carry news sure to be of great interest to low-doc lenders. The basic information that goes into credit reports—one of the few critical documents that low-doc lenders base underwriting judgments on—has some genuine credibility problems, according to a former TRW executive. The August issue also will review the current state of the mortgage insurance industry.

Editor's Note: Some biographical information about an author was inadvertently omitted from a story in the May issue titled "Why Japan Likes U.S. Real Estate." Victor Orth is with Touche Ross & Co. based in Chicago.

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As jobs and employers migrate to new cities, real estate activity registers similar ups and downs.

The Job Growth Barometer—

WHERE THE HOT MARKETS ARE

Coastal cities in the Northeast and West are beginning to show marked signs of an economic slowdown that could affect local real estate markets. At the same time, manufacturing and energy belt markets in the central and northwestern United States are showing new signs of growth.

The 1983-87 period could arguably be called a period of the "bicoastal" economy. By constrast, current economic growth patterns would perhaps best be described as a "non-coastal" economy.

These changes are clearly shown by comparing current employment growth in several metropolitan areas with established local trends since the end of the 1982 recession. Cities that recently either started growing faster or slower than in the prior five years are undergoing economic change that could be a sign of different conditions in the real estate markets as well.

Of course, with the national economy growing more slowly in this seventh year of recovery, most cities are growing more slowly. However, the dropoff in growth in certain areas is more substantial than the decline in national growth rates. On the other hand, some cities recently experienced faster growth than they recorded earlier in this decade.

A complete understanding of local, commercial or residential real estate market conditions requires a wide variety of detailed local information. But investors interested in many real estate markets can monitor important changes by tracking overall economic growth in each area. Growth is normally a good measure of real estate demand. Any unanticipated slowing in overall economic growth probably would result in higher real estate vacancy rates and in the residential market. Likewise, an unanticipated surge in economic growth probably would cause tightness in both the commercial and residential markets.

Salomon Brothers tracks total employment growth in 95 large metropolitan areas in the U.S. as part of its overall real estate research effort. We have found that the employment estimates are the most comprehensive, local area economic data that are both readily available and reasonably current. But, in order to use this data, one needs some context for it. Our research found that changes in employment levels in each city compared with that market's own recent performance and the current experience of other cities is a good, simple measure of overall economic trends.

In this article, we analyze growth in non-agricultural employment in 95 metropolitan areas during the past 12 months (February 1988 to February 1989). To assess this recent growth, we compared the near-term growth rates of all the sample cities and we further compared the recent growth rates with each city's post-recession trend. (Charts 1a and 1b present the recent growth rate compared with the February 1984 to February 1988 growth rate.)

Cities recently showing greater growth than their trend for most of

Robert E. Hopkins

ILLUSTRATION BY ERIC WESTBROOK

CHART 1A

Improving Growth Rate Cities.

Total Nonagricultural Employment Growth Rate, Feb 1984–88 and Feb 1988–89 and Change in Growth Rate

Rank	Metropolitan Area	Average Growth Rate 1984–88	Growth Rate 1988–89	Diff
1	Houston TX	0.8	3.4	4.1
2	Gary Hammond IN	1.0	2.6	3.6
3	New Orleans LA	0.9	1.1	2.0
4	Oklahoma City OK	1.0	0.7	1.7
5	Tulsa OK	0.2	1.4	1.6
6	Akron OH	2.7	3.8	1.1
7	Baton Rouge LA	1.6	2.5	0.9
8	Rochester NY	3.1	3.7	0.6
9	Las Vegas NV	7.8	8.2	0.4
10	Cleveland OH	2.2	2.6	0.4
11	Pittsburgh PA	1.2	1.3	0.1
12	Omaha NE IA	3.9	4.0	0.1

CHART 1B

Declining Growth Rate Cities.

Total Nonagricultural Employment Growth Rate, Feb 1984–88 and Feb 1988–89 and Change in Growth Rate

Rank	Metropolitan Area	Average Growth Rate 1984–88	Growth Rate 1988–89	Diff
1	Phoenix AZ	8.7	0.7	8.0
2	Riverside San Bernardino CA	9.6	2.0	7.6
3	Orlando FL	10.3	4.0	6.3
4	Tucson AZ	6.7	0.6	6.2
5	Nashville TN	6.8	0.8	6.0
6	Austin TX	5.9	0.4	5.5
7	Raleigh Durham NC	7.4	2.3	5.1
8	Columbia SC	6.0	1.0	5.0
9	Anaheim Santa Ana CA	7.3	2.4	5.0
10	Greensboro—Winston Salem—High Point NC	5.5	0.7	4.7
11	Norfolk Virginia Beach Newport News VA	5.9	1.2	4.7
12	Monmouth Ocean NJ	7.1	2.6	4.5
13	Tampa St Petersburg Clearwater FL	7.6	3.3	4.2
14	Atlanta GA	7.2	3.1	4.1
15	Dallas TX	4.8	0.8	4.0
16	Oxnard Ventura CA	6.7	3.0	3.7
17	Fort Worth Arlington TX	5.2	1.5	3.6
18	Charlotte Gastonia Rock Hill NC SC	6.4	2.9	3.5
19	Greenville Spartanburg SC	5.5	2.0	3.5
20	Jacksonville FL	7.1	3.9	3.2
21	Bridgeport Milford CT	3.8	0.7	3.1
22	Fort Lauderdale Hollywood Pompano Beach FL	6.8	3.7	3.1
23	San Diego CA	7.8	4.8	3.0
24	Albuquerque NM	5.4	2.4	3.0
25	Nassau Suffolk NY	4.5	1.6	2.9

The industrial Midwest is currently a story of strong revival after a long U.S. manufacturing recession.

this decade have been concentrated in the energy, farm and industrial belts (see Chart 1a). In the past year, Houston has made the greatest improvement on its prior negative employment trend. Although Houston experienced a net loss in jobs between 1984 and 1988, in the past year it regained 47,000 jobs for a growth rate of 3.4 percent. Similarly, Oklahoma City, New Orleans and Tulsa have moved from negative to positive job growth. In the industrial and farm areas, Gary-Hammond, Akron, Rochester, Toledo, Pittsburgh and Cleveland are now growing at rates above their trend prior to 1988.

Cities experiencing a slowing of their sometimes rapid growth rates are concentrated on the East Coast from Massachusetts to Florida and in the non-energy parts of the Southwest and southern California. The southern California area (which we normally think of as extending to Arizona) is falling off the rapid growth patterns it showed during most of the decade. The slowdown in Phoenix and Tucson, which actually started in 1986, was evident in 1987.

More recently, Riverside, San Bernardino and Orange counties have started to slacken their normally rapid rates of growth (see figure 1b). Even Orlando's growth, which was a very strong 4 percent annual rate last year, was half the area's average rate from 1984 to 1988.

Recent growth patterns in these cities tend to reflect overall conditions in the economic region where the city is located. In addition to the patterns illustrated in the charts, a detailed look at recent history for all the large metropolitan areas shows other interesting regional patterns.

In most of southern California (a region we generally define as including Las Vegas and Arizona), a decline from traditional rapid growth is evident. In most cases, the further away from Los Angeles—the core of the region—the more significant the slowdown. The exception is San Diego which is growing close to prior rates. The Los Angeles hub market is still growing close to its past trend—in excess of 95,000 new jobs a year. None of the region's current slowdown applies to Las Vegas either, which has ranked number one in growth rates fairly consistently since early 1987.

The northern California region (which we extend up to Washington state) is growing strongly in comparison to its recent trends. Seattle, in particular, is benefiting from its diversifying economy and the strength of Boeing as an employer. The company has a backlog of orders well into the 1990s. Portland, San Francisco, Oakland and San Jose all suffered significant downturns earlier in the decade. As a result, recent growth shows a significant improvement over the medium-term trend. Portland and San Francisco are still strong, but San Jose is slipping after a very strong 1988. Sacramento remains on a path of rapid growth.

The mineral extraction area that extends from Louisiana to Idaho has clearly been one of the hardest hit economic regions in the country during the past five years. Several cities there have medium-term growth trends that are negative, meaning that employment now is below the 1983 level. The cities that suffered the most decline—Houston, New Orleans, Oklahoma City and Tulsa—have been improving since the end of 1987. All are currently seeing growth rates above their respective negative growth trend lines, though growth is still slow in most of the cities, except Houston. The cities in that area that are less energy dominated, which continued growing into 1986, have fared less well since then. Austin, Dallas, Fort Worth, San Antonio and Albuquerque are growing below recent trends. Salt Lake City's growth deteriorated through most of 1986 and 1987, but it has revived substantially since early 1988.

There are few cities in the farm belt that are large enough for Salomon Brothers to track closely. Of the four larger cities, three are in relatively good condition, though last year's drought hurt. Omaha, Wichita and Des Moines are improving, while Kansas City had slightly slower growth than normal during 1987 and 1988.

The industrial Midwest is currently a story of strong revival after a long U.S. manufacturing recession. The heavily industrialized cities such as Gary, Allentown, Akron, Cleveland, Pittsburgh and Milwaukee are well above previous growth trends. The revival in these cities did not begin until 1987. The revival in Buffalo and St. Louis has slowed recently. Last year was not a good one for economic growth in Detroit, but 1989 is starting off better. The fate of Detroit is still tied to the automobile industry's competitiveness.

Current economic growth patterns would perhaps best be described as a "non-coastal" economy.

The more diversified cities in the Midwest are generally continuing to perform at rates comparable with the past few years. Chicago, Albany, Cincinnati, Indianapolis and Minneapolis are above trend, while Columbus has fallen slightly behind its prior rapid growth trend. Lake County, a suburb of Chicago, and Allentown, Pennsylvania, an outerlying part of suburban New York, are growing faster than in the past. Lake County is one of the fastest growing metropolitan areas in the country.

Most of the Southeast is a victim of the coastal slowdown. Atlanta's growth fell off in 1987, but growth in the past few months has been notably better. Columbia, South Carolina, Nashville, Raleigh-Durham and Norfolk all have fallen back further than the rest. Even Orlando is growing much more slowly than in the past, though its current growth rate would still be considered rapid by most cities' standards. Southeast Florida is the major exception on the positive side. Fort Lauderdale and West Palm Beach have improved slightly and Miami's growth is well above previous years.

Financial services are no longer spuring the Mid-Atlantic region to the kind of growth rates achieved in the first half of the decade. Finance, insurance and real estate employment is now a drag on New York City growth, rather than a major source of growth. Long Island has also been hurt by the

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defense industry slowdown. Philadelphia, Baltimore and the most rapidly growing suburban New Jersey counties have all slowed their employment growth. However, Wilmington has remained on track and Washington, D.C. continues to add more jobs than most other cities.

Growth rates in New England are modest, but, in most cases, they continue at near recent rates. Despite negative press, Boston's current growth is slow only in comparison with the 1980-84 period. Since 1985, the growth rate in Boston has been very steady. Growth in Worcester is ahead of recent years following a pattern similar to the Midwest. Providence and Hartford are trailing off, however. Since early 1988, growth has been below historical norms in those two areas.

The changes in growth trends in the different regions of the country are partly the result of a number of overall economic factors affecting a broad range of industries. Differences in regional growth have been significant during the past 10 years as the "rolling" recession has swept through various industries and regions. As has always been the case, the economic fate of individual cities and regions is closely tied to the economic fortunes of their major industries or the occupations of their residents. Along some of those lines, the relevant trends we see that are likely to shape regional fortunes are as follows:

- The relative decline in the dollar since 1985 created a surge in manufacturing and domestic distribution-based growth in the industrial Midwest. Employment growth did not become significant until 1987, after interest rates had fallen and new construction in that area began. Now, the Midwest is benefiting from secondary effects of the manufacturing growth. For example, because economic opportunities are much greater in that region and the brain drain of young technical talent has abated, the smaller, Midwestern cities have become more attractive places for research or management activities that earlier would have been located on the coasts. The substantial rise in the dollar this spring is the largest threat to the continuation of the positive job growth trend in the industrial areas. Although we do not expect the Midwest recovery to be reversed, a continued rise in the value of the dollar could slow it.

- The extremely high housing costs in California, New York and New England are a deterrent to corporations locating in these areas that cannot afford to pay their employees bloated housing expenses. In an era of corporate cost-cutting and restructuring, a wide diversity in house prices or other living expenses among regions will continue to influence the path of business migrations.
- The slowdown in financial services and the restructuring in the banking and thrift industries has had a disproportionate affect on job growth and the economy in the Northeast. Continued announcements of minor layoffs at commercial and investment banks indicate that this trend will not be reversed in the near future.
- Layoffs at defense plants in California, Long Island, Georgia and elsewhere have resulted from the completion of older contracts and a reduced or uncertain supply of new orders. Federal budgetary pressure, reduced "cold war" tension and a greater public willingness to consider defense cuts have resulted in a reduction or a stretching-out of major military procurement programs. Civilian aircraft production, by contrast, is booming—pushing Seattle employment gains into the same league as much larger cities.
- Congestion, unaffordable housing and growth restrictions, in the past, have pushed growth and development into outlying counties around the strongest growth areas. Cities from Providence, Rhode Island to central New Jersey, to Riverside, California, have in a sense, benefitted from the overflow from congested central cities. But, this makes these counties vulnerable to a slowdown because, as growth pressures on the central city are eased, it may not be necessary for outlying areas to absorb this overflow. Nevertheless, some well-established peripheral areas have shown no signs of a drop-off in growth. **MB**

Robert E. Hopkins is vice president of the real estate research department at Salomon Brothers, Inc.

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VITAL STATISTICS

INTEREST RATES & YIELDS
1- TO 4-FAMILY MORTGAGES

	FHA OPINION SURVEY	FHLBB			FNMA		FHLMC	
1989	FHA New Homes[1]	CONVENTIONAL[2] FRM	CONVENTIONAL[2] ARM	Median Cost of Funds FSLIC Institutions	1-Yr. ARM	FRM Conv.	ARMs	FRMs
FEB	10.79%	10.80%	9.07%	7.59%	9.64%	10.65%	8.65%	10.65%
MAR	11.02	10.83	9.24	7.71	10.07	11.09	9.09	11.03
APR	11.02	10.93	9.41	7.84	9.80	10.94	9.40	11.05
MAY	**NA**	**11.14**	**9.75**	**NA**	**9.46**	**10.55**	**9.30**	**10.77**

SELECTED SECURITIES

		PRIME	U.S. GOVERNMENT				
1989	FEDERAL FUNDS RATE	COMMERCIAL PAPER (3-Month)	6-Month	1-Year	3-Year	10-Year	A-Rated Utility
FEB	9.36%	9.37%	8.55%	9.25%	9.32%	9.17%	10.25%
MAR	9.85	9.95	8.85	9.57	9.61	9.36	10.37
APR	9.84	9.81	8.65	9.36	9.40	9.18	10.33
MAY	**9.81**	**9.47**	**8.43**	**8.98**	**8.98**	**8.86**	**10.09**

CURRENT SECONDARY MARKET YIELDS

SPREADS
(Basis Points)

1989	GNMA[3]	FNMA[3]	FHLMC[3]	GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
FEB	10.37%	10.33%	10.33%	120	116	116
MAR	10.63	10.58	10.57	127	122	121
APR	10.58	10.55	10.54	140	137	136
MAY	**10.29**	**10.31**	**10.30**	**143**	**145**	**144**

SECONDARY MARKET ACTIVITY
(Dollars in Millions)

	FNMA				FHLMC				GNMA	
	Portfolio		Mortgage-Backed Securities						Pass-Through Securities	
	Commitments	Purchases	Out-Standing	Issued	Commitments To Sell	Commitments To Buy	Mortgages Purchased	PCs Issued	Applications	Issued
JAN 1989	$1,087	$1,037	$180,822	$4,074	$3,492	$5,206	$3,586	$3,408	$4,830	$4,584
FEB	3,557	905	184,209	4,811	6,360	8,411	5,088	4,900	2,000	3,990
MAR	1,771	1,469	188,071	5,473	7,134	11,227	6,373	6,037	5,620	3,902
APR	**1,118**	**1,163**	**191,420**	**4,407**	**5,945**	**4,196**	**5,861**	**5,554**	**3,513**	**3,983**
1988 TOTAL	23,435	23,110	---	54,878	41,271	70,669	44,075	39,777	58,579	56,532
1987 TOTAL	25,415	20,531	---	63,230	68,210	76,615	76,840	75,018	116,611	96,983
4 MONTH AVG. 1989	1,883	1,144	---	4,691	5,733	7,260	5,227	4,975	3,991	4,115
1988	2,787	2,270	---	3,417	2,477	4,869	2,791	2,206	3,406	3,478
1987	1,968	1,469	---	5,669	8,452	10,818	8,771	8,764	12,881	10,574

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES

(Units in Thousands, Seasonally Adjusted Annual Rates)

	BY TYPE OF UNIT						BY REGION							
	HOUSING STARTS			BUILDING PERMITS			HOUSING STARTS				BUILDING PERMITS			
1988	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units	Northeast	Midwest	South	West	Northeast	Midwest	South	West
JAN 1989	1,678	1,265	413	1,486	1,127	359	293	313	642	430	229	290	563	404
FEB	1,465	1,091	374	1,403	1,077	326	224	273	572	396	204	286	522	391
MAR	1,399	1,037	362	1,230	942	288	153	306	351	389	182	251	446	351
APR	**1,361**	**1,104**	**257**	**1,318**	**1,009**	**309**	**208**	**277**	**529**	**347**	**188**	**258**	**506**	**366**
1988 TOTAL	1,488	1,140	348	1,463	1,083	380	235	274	575	404	234	269	548	413
1987 TOTAL	1,621	1,212	409	1,535	1,114	421	269	298	634	420	272	282	575	406
4 MONTH AVG. (SAAR)														
1989	1,476	1,124	352	1,385	1,039	346	220	292	524	391	228	271	509	394
1988	1,504	1,153	351	1,401	1,053	348	292	273	556	383	273	260	503	365
1987	1,743	1,310	433	1,665	1,217	448	298	359	634	452	302	337	594	433

HOME SALES

(Units in Thousands)

	EXISTING HOMES			NEW HOMES		
1988	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate
JAN 1989	3,550	2,400	8.1	700	369	6.4
FEB	3,480	2,450	8.5	624	374	7.6
MAR	3,400	2,470	8.7	559	374	8.0
APR	**3,360**	**2,640**	**9.4**	**620**	**373**	**7.5**
1988 TOTAL	3,594	---	---	676	---	---
1987 TOTAL	3,526	---	---	671	---	---
4 MONTH AVG. (SAAR)						
1989	3,448	---	---	626	---	---
1988	3,318	---	---	643	---	---
1987	3,603	---	---	726	---	---

VALUE OF NEW PRIVATE CONSTRUCTION PUT IN PLACE

(Units in Billions of 1982 Dollars, Seasonally Adjusted Annual Rates)

Total[5]	1–Unit	2+ Units	Nonresidential
$290.0	$108.1	$19.6	$81.6
287.2	107.2	20.3	80.9
291.8	105.1	20.9	84.5
288.4	**102.6**	**21.6**	**80.4**
281.8	103.5	19.3	77.9
283.0	100.7	22.4	78.2
289.4	105.8	20.6	81.9
278.7	103.0	19.6	77.4
281.7	99.2	24.3	75.9

LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED

By Type of Institution and By Type of Unit

(Dollars in Millions)

	1-4 UNITS					5+ UNITS					NONRESIDENTIAL				
1988	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies
NOV	$28,138	$5,430	$14,704	$7,314	$352	$3,406	$600	$1,605	$659	$271	$11,252	$23	$1,496	$6,546	$3,090
DEC	32,145	6,459	16,502	8,356	455	4,686	404	2,450	874	628	20,455	224	2,389	11,859	5,879
1989 JAN	25,794	5,286	12,352	7,754	72	2,956	561	1,433	396	329	10,533	121	1,604	7,598	1,146
1989 FEB	**22,877**	**4,494**	**10,851**	**7,125**	**112**	**2,998**	**131**	**1,366**	**880**	**401**	**9,540**	**38**	**1,343**	**6,986**	**1,071**
1988 TOTAL	374,401	85,307	186,237	95,474	3,190	37,876	4,526	20,379	6,988	3,553	175,754	1,032	22,953	119,942	29,714
1987 TOTAL	449,544	110,093	208,054	124,551	3,209	44,981	2,409	22,492	8,299	3,547	168,652	2,871	25,613	110,490	28,160
2 MONTH AVG. 1989	24,336	4,890	11,602	7,440	92	2,977	346	1,400	638	365	10,037	80	1,474	7,292	1,109
1988	21,192	5,591	9,734	5,515	47	2,223	273	1,286	361	153	13,388	39	1,674	10,128	1,422
1987	33,249	9,402	13,101	10,282	218	3,751	376	1,545	685	134	9,993	356	1,583	6,699	1,265

MORTGAGE INSURANCE

(Units in Thousands, Dollars in Millions)

	APPLICATIONS RECEIVED (Units)				LOANS INSURED							
	TOTAL	FHA[8]	VA	PRIVATE	TOTAL		FHA		VA		PRIVATE	
					Units	Amount	Units	Amount	Units	Amount	Units	Amount
1989 JAN	107	60	16	31	121	$8,656	76	$4,629	17	$1,240	28	$2,787
FEB	114	68	15	31	93	6,817	56	3,509	16	1,223	21	2,085
MAR	147	86	16	45	95	7,142	51	3,189	18	1,364	26	2,589
APR	**135**	**76**	**15**	**44**	**91**	**6,974**	**49**	**3,064**	**15**	**1,127**	**27**	**2,783**
1988 TOTAL	1,755	949	211	595	1,334	98,012	699	42,577	211	15,771	424	39,664
1987 TOTAL	2,340	1,211	408	721	2,282	159,668	1,320	81,881	451	33,312	511	44,475
4 MONTH AVG. 1989	126	73	16	38	101	7,398	58	3,598	17	1,239	26	2,561
1988	147	86	15	46	102	7,279	55	3,310	18	1,266	29	2,703
1987	261	157	43	61	205	14,163	120	7,433	46	3,352	39	3,378

NA—Not Available; SAAR—Seasonally Adjusted Annual Rate

[1] Secondary market gross yields. Numbers shown for each month are the average of yields from the first day of the month shown and the first day of the subsequent month.

[2] Effective rate on loans closed.

[3] Securities for 0 to 30 day delivery.

[5] In addition to the categories of private construction shown, the total also includes these categories: residential improvements, railroads, electric light and power, gas, telephone and telegraph, petroleum pipelines, and farm nonresidential.

[6] In addition to the categories shown, the total also includes private pension funds, private MBS conduits, state and local retirement funds, Federal credit agencies, mortgage pools, and state and local investment agencies.

[7] Savings & Loans and Mutual Savings Banks.

[8] FHA applications received includes the Direct Endorsement Program.

AUGUST 1989

MORTGAGE BANKING

THE MAGAZINE
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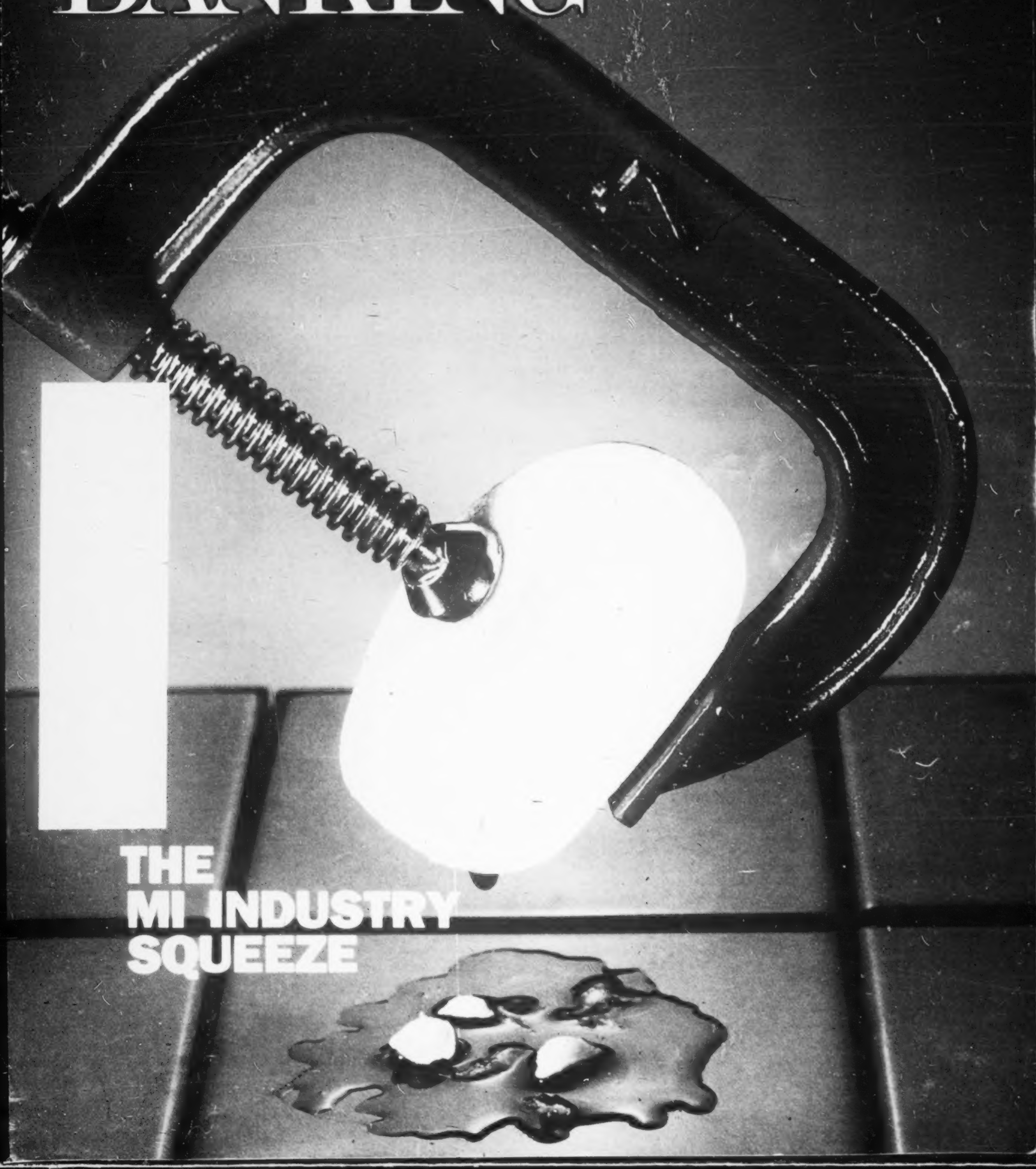


THE MI INDUSTRY SQUEEZE

CONTENTS

AUGUST 1989 VOLUME 49 NUMBER 11

COVER: Private Mortgage Insurance

The mortgage insurance business thrived for a long time until the industry encountered its first underwriting loss in 1982. It was an industry basking in the sunshine until it was caught unprepared in the grip of a stark rise in claims. The industry's major preoccupation in the good time years of almost guaranteed appreciation was how to meet steadily rising sales goals. Then suddenly it was over and the MIs were being squeezed by unprecedented market forces. Now, some MIs are on their way back but the business will never return to the days when marketing was king.

12 **Feeling the Squeeze** *The MI industry has been hit hard in recent years by high claims, dwindling market share and a move toward self-insurance. But the industry is battling back on several fronts.* By DONA DEZUBE

22 **The TMIC Aftermath** *A unique mortgage insurance company was spawned by the MIs to cover the loans left uncovered by TMIC's liquidation.* By BILL THOMAS

26 **Housing the Rank and File** *One mortgage insurer has teamed up with local lenders, Fannie Mae and community groups to help low-income renters become homeowners.* By GREGORY T. BARMORE

32 **Credit Reports: Faulty Files?** *A credit report may have credibility problems of its own.* By JAMES R. WILLIAMS, JR. AND PATRICK E. BOSOLD

Servicing

39 **Servicing Sales: Disappearing Dollars** *Both buyers and sellers of servicing need to explore hidden aspects of a transaction that can make the sale or purchase more or less profitable long after the deal closes.* By JAY H. WIENER

Income Property

49 **Income Property Lending—Some Concrete Advice** *Should lenders care if an apartment building is built with wood versus concrete? Maybe so.* By TONY HERRLING

Management

55 **An Industry Problem: Inadequate Fidelity/Fraud Coverage** *The formulas now used by mortgage bankers to compute needed business coverage against losses may be perpetuating a serious insurance shortfall.* By WILLIAM I. DE HUSZAR, CMB

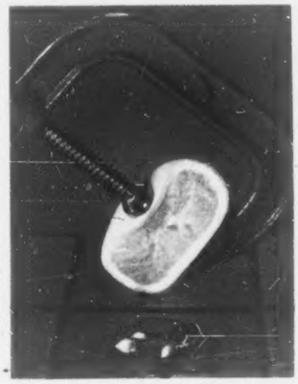
DEPARTMENTS

9 BUSINESS ALERT
11 BOARDROOM VIEW
62 PEOPLE
65 THE SECONDARY MARKET
67 ECONOMIC TRENDS
71 INDEX TO ADVERTISERS

COVER PHOTOGRAPHY BY BOB GROVE

PORTFOLIO

MIs: A Double Standard



Mortgage insurers went from feast to famine almost overnight in the early 1980s. They've endured a market share squeeze that began in mid-decade and since then, have watched even more business slip away to self-insuring thrifts. It's little wonder they're now in the mood to fight back.

Throughout the 1980s, MIs were hit hard by soaring claims that rocked the once tranquil and profitable insurance niche. In February 1987, Roger F. Blood, of Temple, Barker & Sloan, Inc., wrote in this magazine that the MIs went from booking total losses of "just $39 million in 1979" to a five-fold increase in losses by 1982. Blood wrote: "In 1982 alone, the loss ratio more than doubled from the previous year, triggering the industry's first underwriting loss—$40 million—versus a $70 million gain in 1981. The housing recovery and record new business volumes could not match the rampant increase in claims. By 1985, the industry loss ratio had redoubled to 120 percent, with total losses topping $1-billion."

The experience was a financial disaster for the industry. They emerged later in the decade sobered by their losses and convinced that the smart business plan was to avoid high risk. This prompted a hasty retreat from the oil belt states and from the low down payment loan. The shift is documented in HUD and MICA data that show the MI's market share in six of the hardest hit states went from 43 percent in 1984 to 9 percent in 1987. The retreat left the low down payment borrower in these states (Alaska, Colorado, Florida, Louisiana, Oklahoma and Texas) with no alternative but FHA. As a result, FHA's market share in these states went from 9 percent to 29 percent during this period.

MIs learned the hard way that the only way to manage risk is to take assertive steps to seek out low-risk business to balance the high-risk business. But the mortgage insurers, by their lobbying efforts in Washington, would have Congress deny the FHA that same opportunity to seek out a prudent measure of additional lower risk business even though it is taxpayers' money at issue, (not stockholders' money invested by choice in an MI.) By this we are referring to the MIs' lobbying campaign to block Congress from raising the FHA loan limits. Raising the loan limits to 95 percent of a market's median sales price, as proposed, would allow the FHA to continue to capture a small amount of lower risk business in healthy housing states like California. Without such a measure, FHA would be locked into serving, with no offsetting risk benefit, the higher-risk borrower the MIs couldn't wait to abandon.

Janet Reilley Hewitt
Editor

COMING IN SEPTEMBER

A Smaller Industry

The president of SMR Research focuses on the fundamental restructuring that's occurred in the mortgage banking industry during the last year and the reasons prompting some players to leave the business.

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An Industry Problem:

Inadequate Fidelity Fraud Coverage

Old formulas used to determine mortgage bankers' bond coverage amounts are proving inadequate. Uncovered losses recently have driven companies to bankruptcy.

The size and number of fidelity and fraud loss claims submitted to Underwriters at Lloyd's, London for payment under the Mortgage Bankers Bond program have remained at an alarmingly high level during the past year. This has been the case despite efforts by a large number of mortgage banking firms to reduce or control the incidence of large fidelity and fraud losses through quality control and periodic internal audits.

Furthermore, another disturbing trend has emerged that mortgage bankers now must deal with—a dramatic increase in fidelity and fraud losses that are not adequately insured.

Losses covered under MBA's bond program and paid for by Underwriters (See Chart 1) can have adverse impact on the company sustaining the loss in the form of higher premiums. But losses exceeding coverage amounts, or those not covered at all can either hamper the mortgage banker's financial wherewithal to conduct business, or put the firm out of business entirely.

During the past two years, uncovered losses have driven several companies to bankruptcy and often resulted in substantial losses for their investors as well. All in all, these losses have drained the industry unnecessarily of much needed capital.

These developments not only affect the financial health of the mortgage banking industry, but also cast a shadow on the professionalism and reputations of the individual companies involved.

A review of the fidelity bond purchasing habits of mortgage bankers indicates they normally do not assign a high priority to determining the correct bond amount or purchasing appropriate coverage. Typically, they fail to assess and evaluate the risks and exposures of their business in dollar terms, and instead, simply follow the dictates of their secondary market investors' fidelity bond formula. Mortgage bankers then typically purchase coverage in the required minimum amount. Thus, the face value of the fidelity bond often proves inadequate to cover major losses.

The purposes of this article are: to demonstrate that the current formula is no longer a reliable indicator for determining adequate fidelity, fraud and errors and omissions coverages; to suggest a new and more flexible bond formula to help reduce the incidence of underinsurance; and to recommend several new audit steps (and reemphasize the use of certain old ones) to reduce the incidence of fidelity and fraud losses.

Fidelity and fraud losses

Presently, there are more than 400 mortgage bankers in MBA's Mortgage Bankers Bond program.

Bankers Insurance Service Corp., the program's administrator, has pre-

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pared a chart (Chart 1) that provides information on the losses incurred during the past six years. Some of these claims are still being processed, or being paid by Underwriters at Lloyd's, London through their claim settlement attorneys. Losses that occurred but were underinsured, while not shown, are currently estimated to exceed the totals of all covered losses in each of the years shown.

The loss histories presented in the accompanying sidebar constitute the major types of losses that occurred repeatedly during the past three years. They are the type that normally cause underwriters to become wary of mortgage bankers' operating practices and their abilities to contain or prevent fidelity or fraudulent activities. More alarming, however, for mortgage bankers beyond the total dollar amount of losses shown in Chart 1 (many of which will be paid eventually by Underwriters) are the losses that will not be reimbursed because they were either not insured or inadequately insured. Loss amounts in all but two of the cases described in the sidebar exceeded coverage—some by a nominal amount and others by a staggering four to five times the amount of fidelity coverage. In each instance, the mortgage banker carried the minimum coverage prescribed under their secondary market investors' bond formulas.

Because the inventiveness of mortgage banking personnel bent on carrying out fraud outpaced the supervisory controls of the mortgage company and its management, losses have remained high, notwithstanding the widespread implementation of internal audits, quality control practices and compliance with the HUD audit guide. Of course, in many of the companies that were defrauded, actual internal controls and supervision were practically non-existent. Also, it should be noted that while total premiums under the program have increased during the past three years, so have the dollar amounts of losses, if not the number of loss cases.

From present indications, the final results on losses for 1988 do not promise any improvement on 1986 or 1987 results, with premium income now stabilized at the $12 million level. Therefore, if losses rise, without any premium income increases through increased coverage or added participation in the program or both, loss ratios may again increase beyond 100 percent. That could endanger current bond pricing and ultimately the viability of the program.

Actual experience has shown there is little correlation between the size of the company, measured either by the size of its servicing portfolio or its net worth, and the size of loss it could sustain. Small companies reported large losses and large ones recorded small losses.

Losses resulted usually when companies extended their operations into as yet unknown territories, or into untested activities. This was done often too quickly and firms jumped in frequently with both feet. Losses also were more likely when lines of communication were stretched beyond manageable distances, whether they involved branch offices or construction lending. Several of the most recent, sizable losses were sustained simply because management focused on aggressive origination practices, with an inadequate number of supervisors and poorly trained, new personnel; the staff was never able to cope with the large volume of new loan business.

History of the bond formula

In order to support the notion that the formula currently in use—based solely on servicing (or origination) volume—is no longer a reliable one and to suggest a new one, we must review how and why this formula was adopted initially.

CHART 1

Mortgage Bankers Bond

Calendar Year Loss Claims Data (Fidelity & Fraud) (Errors & Omissions)

	1983	1984	1985	1986	1987	1988
Number of Cases Reported	31	47	37	55	41	44‡
Number of Bond Program Participants	245	273	350	350	373	411
Claims Paid & reserved and all expenses	1,708,348	3,511,896	5,065,607	10,747,220‡	8,959,190‡	5,525,664‡
Gross Annual Premium	1,761,184	2,295,416	5,723,850	9,682,180	12,272,864	12,000,000
Combined Loss & Expense Ratio	97.0%	153.0%	88.5%	111.0%	73.0%	47.0%

‡It may take several years after a loss is reported before the total amount of a loss is established and agreed upon. Consequently, the amounts reserved and subsequently to be paid for 1988, 1987 and even 1986 can only be estimated. From all current indications, losses and expenses for 1988 are expected to reach or exceed 1987 estimated claim and expense amounts.

Loan origination fraud schemes

Two almost identical fraud schemes, both in concept and execution, were conceived and carried out in two unrelated companies 3,000 miles apart. Both frauds (cases one and two) were perpetrated in branch offices and both involved single-family loan originations. Furthermore, both losses far exceeded $1 million, with final accounting yet to be completed.

One large company operating nationwide from the East Coast was defrauded in one of its California branch offices; the other company based in California reported similar losses in one of its East Coast offices.

In each case, the key perpetrator of the fraud scheme established a fictitious real estate firm through which fraudulent applications bearing fraudulent borrowers' signatures were processed. Bank account verifications and other credit data were verified through the services of a fictitious bank and by fictitious credit agencies. All documents were prepared and signed by an accomplice employed by the real estate firm.

In both instances, the properties did exist; the appraisals were prepared by an unscrupulous appraiser who in effect "sold" his services. The loans were insured by title companies and private mortgage insurers and closed in the names of non-existent owners. The perpetrators made one or two payments on some of the loans so that the company would not be alarmed; then they suddently stopped paying and foreclosures and the collapse of the scheme followed.

Both losses were in the millions, and while the losses were paid under the

When the Mortgage Bankers Bond was first conceived in the early 1950s and then offered in the form of a mortgage bankers blanket bond, the only common denominator found appropriate to calibrate the size of fidelity and fraud, and errors and omissions coverages for each mortgage company was the size of the firm's servicing portfolio. The blanket bond incorporates fidelity and fraud protection with errors and omissions coverage—an insurance industry first at the time.

However, when the formula was finally accepted by MBA at the urging of savings banks—the major buyers of residential loans in the 1950s and 1960s—a caveat was issued. The caveat subsequently was heavily stressed by successive chairmen of MBA's insurance committees. It cautioned that the coverage formula based on a company's servicing volume be used only as a "guide" and that the size of the company's net worth, the size of its warehouse lines, the size of the custodial funds in its care and activities such as construction lending, also should be considered as added risk factors in setting an appropriate fidelity bond amount.

The formula worked fairly well during the first 20 years of its use. But more recently, dramatic changes have transformed the entire business of mortgage lending. Particularly residential lending has shifted away from the traditional, piecemeal, loan origination process toward the mass pro-

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Mortgage Bankers Bond, parts of both losses were paid under a bond maintained by the company's parent. Without this additional coverage, some of the losses would not have been paid. Both losses occurred while the companies claimed to have adequate internal controls in place. In actuality, both companies' loan origination units were overwhelmed by a surge of volume and had either relaxed internal controls or were unable to maintain active supervision of their loan solicitors and processors.

(Losses similar in concept, as well as in execution, in amounts of $500,000 to $5 million have also been reported by an additional seven mortgage banking firms throughout the past two years—some fully covered but the majority only partially covered under the bond.)

Diversion of collections and custodial funds

In two other instances (cases three and four) acts of dishonesty were discovered during an audit by a regulatory authority in one instance, and by a secondary mortgage investor in the other. In each case, it was discovered that funds belonging to investors were not remitted and custodial funds were not properly recorded, accounted for and disbursed. Also, bank accounts were not reconciled.

Both cases, which are still under investigation, reveal poor or non-existent controls, lack of management involvement in serious internal problems and the failure of the corporations' auditors to suspect, detect and report irregularities that became increasingly evident. These delays allowed nefarious practices to go undetected for a longer period of time.

In both companies, prior to, or concurrent with the diversions of funds, accounting and servicing records were in chaotic conditions. Had management been more alert and the respective company's auditors been on their toes, the size of the embezzlements could have been contained. In both instances, the dishonest employee was in effect aided by his superiors' lack of attention or knowledge of the scope and size of the problem.

Diversion of funds to non-existent construction projects

Another case (case five) involves an extensive fraud scheme involving kick backs and construction pay-outs to contractors and builders for projects where no construction had taken place. Here a trusted officer in sole charge of construction pay-outs diverted construction funds to advance his own unauthorized projects and solicited and accepted bribes and kickbacks from his contractors and clients.

Because the perpetrator was held in high regard by his peers, little supervision was exercised over his activities and his misdeeds were not discovered until one of his clients reported his dissatisfaction with the treatment accorded by the officer.

The amount of the loss after recoveries was four times as large as the amount of the fidelity coverage. Because the fraud was perpetrated over several years, the diverted funds were not missed and were reflected in lower profitability for the years involved. The final loss amount, although it reduced net worth substantially, did not bankrupt the company. The company had no internal auditor and its internal controls were non-existent. Lack of supervision, as well as the faith placed in this employee by management, contributed greatly to this fraud perpetrated over several years.

Double pledging of collateral

Through double pledging of loan documents, a corporation's cash position can easily be increased and the extra funds easily diverted.

In this particular case (case six), the perpetrator of the fraud borrowed funds from one bank using the original note and a full set of loan documents as a pledge. Shortly after the completion of this transaction, he withdrew the original note (with a plausible explanation to the bank) on "trust receipt" and used the same note and a set of duplicate loan documents to borrow again from another bank. This worked so well that in several instances the same procedure was repeated on a third occasion using a third warehouse lender.

The discovery of these transactions was delayed for a considerable time through internal maneuvering of funds using the second (or third) borrowing to repay the first, etc. Sooner or later, however, the funds available to be shuffled were depleted through diversion of money to the perpetrator's personal account and the scheme collapsed.

(Each loss case presented has been condensed and altered slightly to protect the identity of the company that sustained and reported the loss. Some of these cases are still the subject of settlement negotiations.)

duction of loans (often employing sophisticated loan origination techniques and automated loan processing assembly lines). In the midst of this dramatic change in the business, little has changed on the part of mortgage bankers in assessing new risks and exposures created by these methods and practices.

Substantial losses occurred because companies, with net worths often exceeding millions of dollars but servicing small portfolios, continued to maintain minimum coverage while engaging in a variety of risk-prone activities beyond the relatively simple process of originating and servicing residential loans.

Thus, while loan origination practices modernized, mortgage bankers generally continued to rely on the size of the servicing portfolio as their sole guide for determining the appropriate fidelity bond amounts.

The new challenge

Mortgage bankers should attempt to reduce the incidence of uninsured or underinsured losses through internal controls and audits, and through a better and more thorough evaluation of risks than is common today.

Determining the proper fidelity bond amount has never been easy. It has always been considered "an art" rather than a "science." The effort resembles a balancing act on a highwire—finding the proper balance between adequate coverage (with appropriate amounts of deductibles) and a premium the company can afford.

Since the Mortgage Bankers Bond contains protections for two different types of risks: fidelity and fraud on one hand and "errors and omissions" on the other—it appears logical to determine coverage amounts for each type of risk separately. However, that is not current practice. The same formula is used today, as it has been for more than 35 years, for these highly dissimilar types of risks.

Fidelity and fraud protection

The current bond formula promulgated by secondary market investors calls for the amount of fidelity coverage to be based on servicing volume, or the higher of the annual loan origination volume or servicing volume.

But, recent fidelity and fraud losses of all types and sizes (some of which are illustrated in the sidebar) have reaffirmed a long-held belief by many "loss watchers" that the current formula has outlived its usefulness. It is apparent that appropriate changes are needed in the methods or formulas used to determine amounts of fidelity and errors and omissions coverages.

Determining the proper fidelity bond amount has never been easy. It has always been considered "an art" rather than a "science."

A variety of possible solutions should be considered. Recent case histories, for instance, have indicated that the size of a fidelity or fraud loss has been greater in a company where the net worth grew faster than the servicing volume. This is the case when a company brokers loans also, or exclusively, or sells "servicing released" or periodically sells all of its servicing. Therefore, the prime indicator for the fidelity bond amount should be net worth and not servicing volume.

If a formula using a combination of three factors (net worth, origination and servicing volumes) is developed and adopted, it would be incumbent on mortgage bankers to raise the amount of their fidelity bonds gradually to conform to the amount of their net worth utilized in the business. Accordingly, the amount of their fidelity bonds should be reduced only if origination volume slackened and, if through the sale of servicing, the portfolio was substantially downsized. If appropriate, or desired, there could be a choice also of following either the dictates of net worth, origination volume, or the current servicing volume formula and then setting the amount of the fidelity coverage at whichever method provides the higher amount. Or, perhaps the minimum bond amount—now at $300,000—should be pegged at $500,000 and then scaled upward.

Of course, it remains important that the amount of the fidelity coverage accounts for exposures inherent in handling custodial funds, the use of warehouse lines, construction lending and the considerable hazards involved in operating through branch offices, especially if they are located far from the home office. Required coverage amounts are sometimes hard to quantify. But, in these cases, to err on the high side is usually a more comfortable, albeit expensive option.

Mortgage bankers involved in income property lending, whether it be conventional or FHA, and whether it entails construction lending or not, should never rely on the dictates of their servicing volume to select the appropriate coverage amount. Their basic concern should be the protection of the company's net worth and the sums that the company can employ in the business through the use of warehouse lines. Every new venture and/or project should have attendant risks carefully assessed.

Errors and omissions coverage

The current formula used to determine the amount of errors and omissions (E&O) insurance is the same as that for determining the fidelity coverage limit. This is so, even though the types and sizes of losses emanating from either source are totally different. As a result of this inconsistency, a mortgage banker servicing a portfolio of 20 multifamily loans totaling $100 million for instance, is required to carry a minimum E&O coverage of $300,000—a sum which even on its face appears inadequate. A large residential servicer managing a portfolio of nearly $20 billion would be required to carry $20 million worth of E&O coverage—a sum grossly excessive—even though the largest single loan in the portfolio does not exceed $250,000.

It is clear, then, that different minimums and formulas should be developed for mortgage bankers servicing residential loans and for those servicing multifamily/income property loans. Furthermore, the method or formula used to determine errors and omissions coverage should be separated from the process of determining fidelity bond limits.

But, in view of the fact that original loan amounts have increased considerably from the time the original minimum for E&O coverage was set at $300,000, perhaps a minimum of $500,000 makes better sense today. Since the size of servicing portfolios has grown dramatically during the past decade, the upward increase in required coverage amounts should be tapered off as portfolio amounts reach higher levels. Required coverage should eventually be capped at a set amount. After all, the highest E&O loss under the program in this author's recollection, during the past 36 years, did not exceed $350,000.

The "Internal Audit for Mortgage Bankers," published in 1978 by MBA has provided the mortgage bankers with a meaningful guide for controlling and reducing losses. In addition, FHA's "Audit Guide" added several more requirements to help implement quality control practices. These guides provide forceful reminders of the dangers of negligence and poor supervision. They also furnish effective guidelines for the enforcement of proper operating practices and procedures.

But recent experience indicates that some other steps must also be taken to prevent these kinds of losses, in addition to strict adherence to the audit guides. These steps are as follows:

- Involve top management in deciding the fidelity bond amount and in purchasing the fidelity coverage. Only senior officers and the company's board know in the most precise detail the company's strategic business objectives and the plan for achieving these goals. They can best determine maximum exposure. It is recommended that the amount and type of fidelity bond coverage be approved for purchase officially by the firm's board and recorded in the corporate minutes.
- Strengthen formal communication with the company's outside auditors, and advise them of new activities or new methods of operation. Auditors must become thoroughly familiar with all business practices and their potential pitfalls before they start their work. Typically, they are not.
- Outside auditors, in turn, should tighten client supervision in every phase of operation, particularly in check reconciliation procedures and practices. Auditors should not allow an undue lapse of time in the reconciliation of bank accounts, especially custodial accounts involving tax and insurance payments. Similarly, care should be taken to trace cash flow within the company and review the timeliness of remittances and reports, particularly those involving principal and interest payments from mortgagors to investors.

Lenders' tightening measures should also require that all certified audit reports be prepared according to MBA's chart of accounts and that the "Uniform Single Audit Program for Mortgage Bankers" be followed whenever appropriate.

It is suggested that the auditors' certified report include positive assurance to the company's board, and to those who read and rely on the report, that all bank accounts have been properly reconciled.

- Insist that all members of the audit team read the bond and fully understand its provisions, and that they report exclusions and deductibles in their audit reports.
- Ensure that those responsible for internal audit or quality control are not backlogged in their work. Under the pressures of business, quality control steps often lag six months to a year behind—a delay that makes "quality control" meaningless and facilitates irregularities and fraud.
- Auditors employed by mortgage bankers, as well as by lenders or

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governmental agencies, should increase their vigilance whenever there is backlog in any phase or area of a mortgage banker's operations. They should not hesitate to blow the whistle immediately if irregularities or serious problems are detected or even suspected. Many major losses could have been prevented or minimized had those responsible for audit or supervisory review acted promptly on their suspicions and concerns.

- Secondary market investors and Ginnie Mae should amend their instructions regarding fidelity bond requirements to include a reminder that their "requirements" (minimum or otherwise) are designed exclusively for the protection of their interests. Furthermore, secondary market lenders should exercise closer and more frequent scrutiny of their correspondents' fidelity bond and errors and omissions coverages.

All types of losses—whether covered or uninsured—are of serious concern. Their negative impact on the mortgage banking industry as a whole, and on individual mortgage banking firms is considerable and must be minimized. This objective can be achieved through tighter internal controls or more frequent internal audits, and/or through a better method of determining appropriate coverage amounts than is presently used or prescribed.

This article offers some potential solutions. But there may be other approaches deserving consideration.

Mortgage bankers alone should not be expected to shoulder the entire responsibility for handling this concern. The mortgage banking industry in tackling these problems needs the cooperation and support of the secondary market agencies and MBA as an advocate and guiding force. Furthermore, the issues and questions raised in this article warrant further study. A potential resolution of these issues might be fostered through an MBA task force involving mortgage bankers, lenders and MBA staff, or through the efforts of MBA's Internal Management Committee. **MB**

William I. De Huszar, CMB, is a consultant with Bankers Insurance Service Corp. He served as president of the firm from 1983 to 1985 and then chairman until the end of 1988. Mr. De Huszar is the author of several books and articles on mortgage servicing.

VITAL STATISTICS

INTEREST RATES & YIELDS
1- TO 4-FAMILY MORTGAGES

	FHA OPINION SURVEY	FHLBB			FNMA		FHLMC	
1989	FHA New Homes[1]	CONVENTIONAL[2] FRM	CONVENTIONAL[2] ARM	Median Cost of Funds FSLIC Institutions	1-Yr. ARM	FRM Conv.	ARMs	FRMs
MAR	11.02%	10.83%	9.24%	7.71%	10.07%	11.09%	9.09%	11.03%
APR	11.02	10.93	9.41	7.84	9.80	10.94	9.40	11.05
MAY	10.72	11.14	9.75	NA	9.46	10.55	9.30	10.77
JUN	**NA**	**NA**	**NA**	**NA**	**8.83**	**10.04**	**9.03**	**10.20**

SELECTED SECURITIES

			U.S. GOVERNMENT				
1989	FEDERAL FUNDS RATE	PRIME COMMERCIAL PAPER (3-Month)	6-Month	1-Year	3-Year	10-Year	A-Rated Utility
MAR	9.85%	9.95%	8.85%	9.57%	9.61%	9.36%	10.37%
APR	9.84	9.81	8.65	9.36	9.40	9.18	10.33
MAY	9.81	9.47	8.43	8.98	8.98	8.86	10.09
JUN	**9.53**	**9.11**	**7.93**	**8.44**	**8.37**	**8.28**	**9.65**

CURRENT SECONDARY MARKET YIELDS

SPREADS
(Basis Points)

1989	GNMA[3]	FNMA[3]	FHLMC[3]	GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
MAR	10.63%	10.58%	10.57%	127	122	121
APR	10.58	10.55	10.54	140	137	136
MAY	10.29	10.31	10.30	143	145	144
JUN	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**

SECONDARY MARKET ACTIVITY
(Dollars in Millions)

	FNMA				FHLMC				GNMA	
	Portfolio		Mortgage-Backed Securities						Pass-Through Securities	
1988	Commitments	Purchases	Out-Standing	Issued	Commitments To Sell	Commitments To Buy	Mortgages Purchased	PCs Issued	Applications	Issued
FEB	$3,557	$905	$184,209	$4,811	$6,360	$8,411	$5,088	$4,900	$2,000	$3,990
MAR	1,771	1,469	188,071	5,473	7,134	11,227	6,373	6,037	5,620	3,902
APR	1,118	1,163	191,420	4,407	5,945	4,196	5,861	5,554	3,513	3,983
MAY	**1,742**	**1,419**	**193,681**	**3,762**	**5,233**	**5,186**	**5,141**	**4,474**	**4,452**	**4,115**
1988 TOTAL	23,435	23,110	---	54,878	41,271	70,669	44,075	39,777	58,579	56,532
1987 TOTAL	25,415	20,531	---	63,230	68,210	76,615	76,840	75,018	116,611	96,983
5 MONTH AVG. 1989	1,855	1,199	---	4,505	5,633	6,845	5,210	4,875	4,083	4,115
1988	2,658	2,244	---	3,654	2,429	5,148	2,808	2,230	3,982	3,616
1987	1,920	1,519	---	5,953	8,109	9,688	8,616	8,565	12,349	10,098

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES

(Units in Thousands, Seasonally Adjusted Annual Rates)

	BY TYPE OF UNIT						BY REGION							
	HOUSING STARTS			BUILDING PERMITS			HOUSING STARTS				BUILDING PERMITS			
1988	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units	Northeast	Midwest	South	West	Northeast	Midwest	South	West
FEB	1,465	1,091	374	1,403	1,077	326	224	273	572	396	204	286	522	391
MAR	1,409	1,031	378	1,230	942	288	160	308	552	389	182	251	446	351
APR	1,339	1,091	248	1,334	1,025	309	206	269	525	339	201	258	506	369
MAY	**1,311**	**1,026**	**285**	**1,336**	**975**	**361**	**186**	**245**	**516**	**364**	**179**	**243**	**518**	**396**
1988 TOTAL	1,488	1,140	348	1,456	1,070	386	235	274	575	404	230	266	544	416
1987 TOTAL	1,621	1,212	409	1,535	1,114	421	269	298	634	420	272	282	575	406
5 MONTH AVG. (SAAR)														
1989	1,440	1,101	340	1,358	1,029	329	214	282	561	384	199	266	511	382
1988	1,481	1,133	348	1,408	1,054	354	274	272	557	379	266	263	510	369
1987	1,714	1,286	428	1,628	1,198	430	298	347	632	437	297	335	586	409

HOME SALES

(Units in Thousands)

	EXISTING HOMES			NEW HOMES		
1988	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate
FEB	3,480	2,450	8.5	621	375	7.6
MAR	3,400	2,470	8.7	547	377	8.2
APR	3,400	2,640	9.3	597	377	7.8
MAY	**3,210**	**2,540**	**9.5**	**613**	**382**	**7.7**
1988 TOTAL	3,594	---	---	676	---	---
1987 TOTAL	3,526	---	---	671	---	---
5 MONTH AVG. (SAAR)						
1989	3,408	---	---	616	---	---
1988	3,372	---	---	651	---	---
1987	3,650	---	---	711	---	---

VALUE OF NEW PRIVATE CONSTRUCTION PUT IN PLACE

(Units in Billions of 1982 Dollars, Seasonally Adjusted Annual Rates)

1988	Total[5]	1-Unit	2+ Units	Nonresidential
FEB	$281.2	$104.5	$19.6	$80.3
MAR	284.2	101.6	20.1	82.5
APR	279.7	99.2	21.5	78.0
MAY	**279.0**	**97.5**	**20.0**	**79.8**
1988 TOTAL	281.8	103.5	19.3	77.9
1987 TOTAL	283.0	100.7	22.4	78.2
5 MONTH AVG. (SAAR)				
1989	282.8	102.2	20.2	80.4
1988	278.7	103.0	19.5	77.9
1987	281.7	99.4	23.9	76.1

LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED

By Type of Institution and By Type of Unit

(Dollars in Millions)

	1-4 UNITS					5+ UNITS					NONRESIDENTIAL				
1988	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies
DEC	$32,145	$6,459	$16,502	$8,356	$455	$4,686	$404	$2,450	$874	$628	$20,455	$224	$2,389	$11,859	$5,879
1989 JAN	25,691	5,286	12,315	7,689	72	2,930	561	1,430	373	329	10,425	121	1,599	7,495	1,146
FEB	22,700	4,494	10,821	7,029	61	2,616	131	1,361	837	67	9,512	38	1,337	6,884	1,151
MAR	**29,978**	**5,990**	**14,841**	**8,387**	**83**	**2,361**	**155**	**1,557**	**434**	**51**	**10,272**	**63**	**1,630**	**7,030**	**1,306**
1988 TOTAL	374,401	85,307	186,237	95,474	3,190	37,876	4,526	20,379	6,988	3,553	175,754	1,032	22,953	119,942	29,714
1987 TOTAL	449,544	110,093	208,054	124,551	3,209	41,981	2,409	22,492	8,299	3,547	168,652	2,871	25,613	110,490	28,160
3 MONTH AVG.															
1989	26,123	5,257	12,479	7,702	72	2,636	282	1,449	548	149	10,070	74	1,522	7,136	1,201
1988	23,027	5,940	10,842	5,843	80	2,330	234	1,347	419	176	13,691	54	1,754	10,185	1,466
1987	36,411	10,893	14,584	10,348	330	3,953	274	1,601	701	200	11,148	359	1,687	7,516	1,507

MORTGAGE INSURANCE

(Units in Thousands, Dollars in Millions)

	APPLICATIONS RECEIVED (Units)				LOANS INSURED							
	TOTAL	FHA[8]	VA	PRIVATE	TOTAL		FHA		VA		PRIVATE	
					Units	Amount	Units	Amount	Units	Amount	Units	Amount
1989 FEB	114	68	15	31	93	$6,817	56	$3,509	16	$1,223	21	$2,085
MAR	147	86	16	45	95	7,142	51	3,189	18	1,364	26	2,589
APR	135	76	15	44	91	6,974	49	3,064	15	1,127	27	2,783
MAY	**149**	**91**	**15**	**43**	**93**	**7,109**	**50**	**3,167**	**15**	**1,164**	**28**	**2,778**
1988 TOTAL	1,755	949	211	595	1,334	98,012	699	42,577	211	15,771	424	39,664
1987 TOTAL	2,340	1,211	408	721	2,282	159,668	1,320	81,881	451	33,312	511	44,475
5 MONTH AVG.												
1989	130	76	15	39	99	7,340	56	3,512	16	1,224	26	2,604
1988	152	87	15	49	104	7,468	56	3,357	17	1,246	31	2,865
1987	252	146	42	63	211	14,497	126	7,799	44	3,206	41	3,492

NA—Not Available; SAAR—Seasonally Adjusted Annual Rate

[1] Secondary market gross yields. Numbers shown for each month are the average of yields from the first day of the month shown and the first day of the subsequent month.

[2] Effective rate on loans closed.

[3] Securities for 0 to 30 day delivery.

[5] In addition to the categories of private construction shown, the total also includes these categories: residential improvements, railroads, electric light and power, gas, telephone and telegraph, petroleum pipelines, and farm nonresidential.

[6] In addition to the categories shown, the total also includes private pension funds, private MBS conduits, state and local retirement funds, Federal credit agencies, mortgage pools, and state and local investment agencies.

[7] Savings & Loans and Mutual Savings Banks.

[8] FHA applications received includes the Direct Endorsement Program.

MORTGAGE BANKING

THE MAGAZINE
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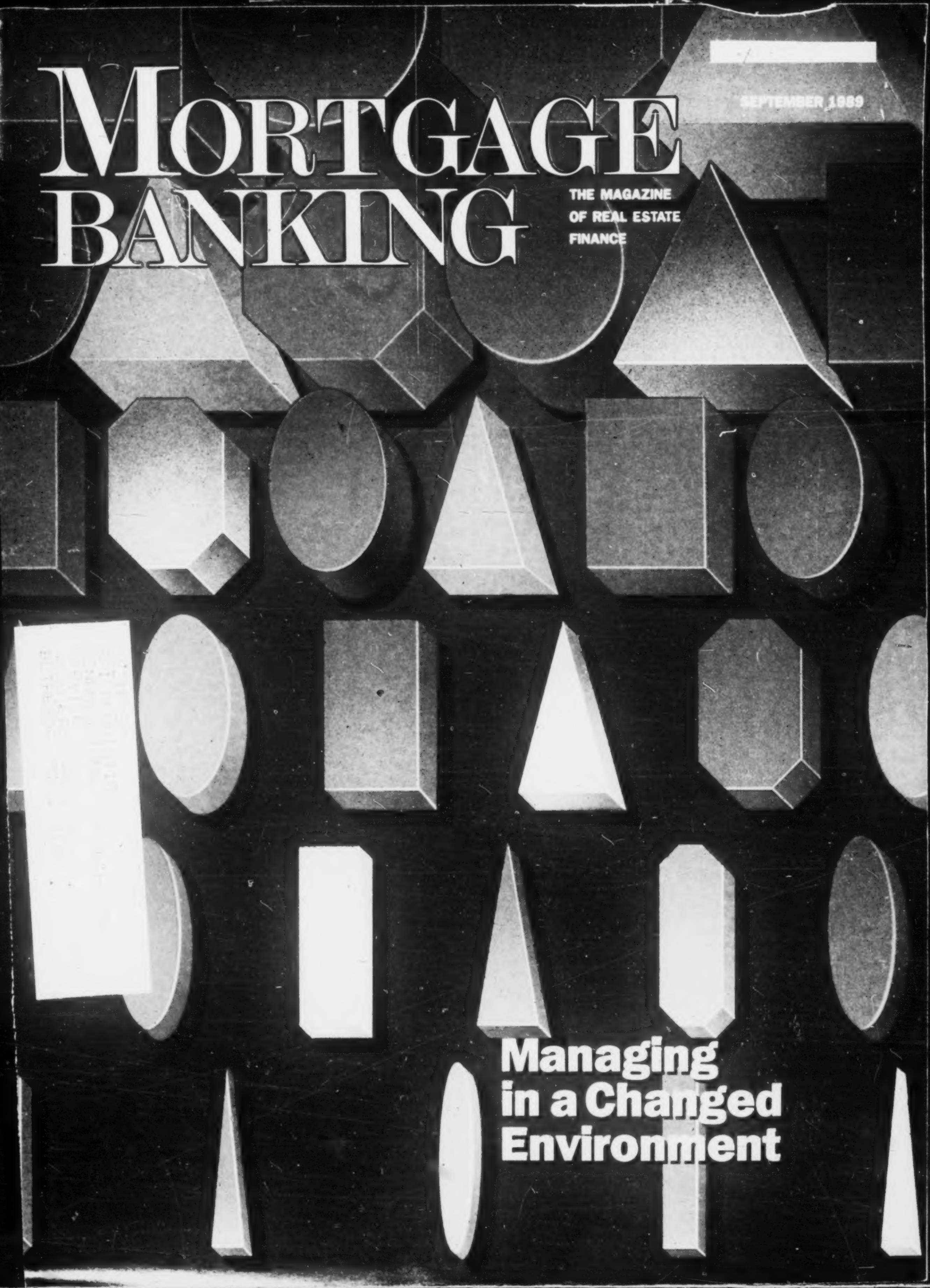
SEPTEMBER 1989



Managing in a Changed Environment

CONTENTS

SEPTEMBER 1989 VOLUME 49 NUMBER 12

COVER: Internal Management

The mortgage banking industry has seen a thinning of its ranks in recent times. At the same time, the business has watched the very largest originators grow still larger. Internal management has played a key role in this chapter of the industry's history. Management has proven both a positive force in helping secure a thriving niche for some firms in these changing times, and it has played a role in the demise of yet others. One clear message emerges—inefficiency, henceforth, is likely to be a terminal flaw.

10 The Changing of the Guard *An overview of some of the trends dramatically reshaping the mortgage lending business.* By STUART A. FELDSTEIN

20 The New Consumer *How will a new breed of consumer and new vehicles for marketing mortgages change the way mortgage bankers do business?* By TERRY ROWLAND

32 Inside Out *Management needs to take a keen look at how their mortgage operations perform internally. Then, the next step is to weed out weaknesses that hamper the ability to take on the outside competition.* By BILL EVANS

Legislative

40 Deficits—A Costly Preoccupation *One economist offers his view of the downside effects of deficit reduction.* By JOHN SIMONSON

The Deficit Does Hurt Us! *Deluding oneself that deficits don't matter is the ostrich approach to the problem.* By RICHARD W. PEACH

Technology

47 How to Buy Software Intelligently *The basic bottom-line questions that you need to ask someone trying to sell you software.* BY ROBERT M. DELF

Income Property

53 Developers: Sizing Them Up *Most lenders have long since dropped the intuitive approach to making loans to developers. What's replaced that method is an extensive investigation of creditworthiness and track record. Here's how to do it.* By THURMAN "TONY" SMITH, JR.

65 Maximizing Returns *How to maximize the value of commercial properties both in the short-term and over the long haul.* By ROBERT D. DUNCAN

Legal Affairs

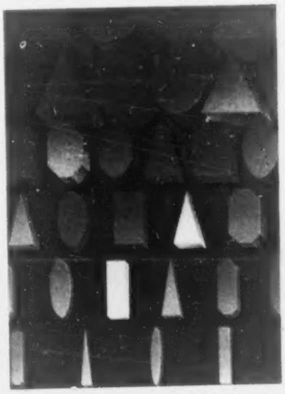
73 Separating Fact from Fraud *A quality control program can help protect mortgage lenders from paying the high price of origination-related fraud.* BY JAMES C. HAGAN

DEPARTMENTS

9 BUSINESS ALERT
79 NEWSMAKER Q&A
81 PEOPLE
83 THE SECONDARY MARKET
85 ECONOMIC TRENDS
91 INDEX TO ADVERTISERS

COVER ILLUSTRATION BY DAVE JONASON

Managing with an Edge



Is the change currently taking place inside the mortgage lending industry permanent and fundamental? Or are these changes the result of this industry's familiar nemesis—cyclicality? Most analysts concede the current restructuring is a result of permanent and powerful competitive forces that are here to stay and that will not look kindly on the old ways of doing business.

The easiest way to take account of the management formulas that now appear on the rise is to review the originations leader board. According to a ranking of the top 10 mortgage originators in this year's first half, the key to winning home loan volume appears to lie in being a large California thrift, a successful wholesaler or a mortgage operation backed by a deep-pocket corporate parent with marketing sophistication and a tie-in to real estate brokerages. Data compiled by *Inside Mortgage Finance*, a trade publication, indicates that the top three originators in this year's first half are the same lenders in the top three spots last year. But there's been a reshuffling. Great Western Financial has taken over the top spot, with Citicorp and its many originating affiliates ranking second, and in third place this year is last year's origination kingpin—Home Savings.

It probably matters little which of the top spots those three lenders hold at any given point in the year. The fact is they are doing something right if they can pull in that large a slice of the pie. What may be significant is who made the list this year that was not in sight last year. Only one lender emerged in this category—Prudential Home Mortgage—with an estimated $2 billion in originations in the first half. This lender's approach is innovative and anything but traditional. Its budding success is probably an indicator of what it will take to run with the successful companies in the years ahead. The consultants maintain that the key to the future will be finding a niche, crafting unique products that pull in volume independent of your sales team and taking advantage of the wholesale dynamic to quickly build your servicing portfolio without branch overhead. The cover story explores these and other trends at work.

Janet Reilley Hewitt
Editor

COMING IN OCTOBER

California—A Prototype?

Does California represent the marketplace of the future for lenders? If so, are there any lessons to be learned from that market about how to crack the affordability problem? Also, what does the future hold in terms of demographic change that could greatly affect housing demand and values?

MORTGAGE BANKING
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VOLUME 49 NUMBER 12

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VITAL STATISTICS

INTEREST RATES & YIELDS
1- TO 4-FAMILY MORTGAGES

	FHA OPINION SURVEY	FHLBB			FNMA		FHLMC	
1989	FHA New Homes[1]	CONVENTIONAL[2] FRM	ARM	Median Cost of Funds FSLIC Institutions	1-Yr. ARM	FRM Conv.	ARMs	FRMs
APR	11.02%	10.93%	9.41%	7.84%	9.80%	10.94%	9.40%	11.05%
MAY	10.72	11.14	9.74	7.99	9.46	10.55	9.30	10.77
JUN	10.32	11.03	10.03	NA	8.83	10.04	9.03	10.20
JUL	**NA**	**NA**	**NA**	**NA**	**8.24**	**9.72**	**8.74**	**9.88**

SELECTED SECURITIES

1989	FEDERAL FUNDS RATE	PRIME COMMERCIAL PAPER (3-Month)	U.S. GOVERNMENT 6-Month	1-Year	3-Year	10-Year	A-Rated Utility
APR	9.84%	9.81%	8.65%	9.36%	9.40%	9.18%	10.33%
MAY	9.81	9.17	8.41	8.98	8.98	8.86	10.09
JUN	9.53	9.11	7.93	8.44	8.37	8.28	9.65
JUL	**9.24**	**8.68**	**7.61**	**7.89**	**7.83**	**8.02**	**9.54**

CURRENT SECONDARY MARKET YIELDS

SPREADS
(Basis Points)

1989	GNMA[3]	FNMA[3]	FHLMC[3]	GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
APR	10.58%	10.55%	10.54%	140	137	136
MAY	10.29	10.31	10.30	143	145	144
JUN	9.77	9.80	9.78	149	152	150
JUL	**9.49**	**9.54**	**9.53**	**147**	**152**	**151**

SECONDARY MARKET ACTIVITY
(Dollars in Millions)

	FNMA				FHLMC				GNMA	
	Portfolio		Mortgage-Backed Securities						Pass-Through Securities	
1989	Commitments	Purchases	Out-Standing	Issued	Commitments To Sell	Commitments To Buy	Mortgages Purchased	PCs Issued	Applications	Issued
MAR	$1,771	$1,469	$188,071	$5,473	$7,134	$11,227	$6,373	$6,037	$5,620	$3,902
APR	1,118	1,163	191,420	4,407	5,945	4,196	5,861	5,554	3,513	3,983
MAY	1,626	1,419	193,681	3,762	5,233	5,186	5,142	4,474	4,452	4,115
JUN	**2,573**	**1,862**	**196,501**	**4,339**	**7,753**	**7,948**	**7,392**	**6,551**	**3,267**	**4,158**
1988 TOTAL	23,435	23,110	---	54,878	41,271	70,669	44,075	39,777	58,579	56,532
1987 TOTAL	25,415	20,531	---	63,230	68,210	76,615	76,840	75,018	116,611	96,983
6 MONTH AVG.										
1989	1,955	1,309	--	4,447	5,986	7,029	5,574	5,154	3,947	4,119
1988	2,578	2,265	---	4,081	2,747	5,452	3,026	2,466	4,146	3,942
1987	1,891	1,547	---	6,069	7,887	9,122	8,490	8,377	12,637	9,793

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES

(Units in Thousands, Seasonally Adjusted Annual Rates)

	BY TYPE OF UNIT						BY REGION							
	HOUSING STARTS			BUILDING PERMITS			HOUSING STARTS				BUILDING PERMITS			
1989	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units	Northeast	Midwest	South	West	Northeast	Midwest	South	West
MAR	1,409	1,031	378	1,230	942	288	160	308	552	389	182	254	446	351
APR	1,343	1,091	252	1,334	1,025	309	207	274	526	339	201	258	506	369
MAY	1,309	1,017	292	1,347	970	377	180	246	518	365	179	245	528	395
JUN	**1,400**	**1,028**	**372**	**1,300**	**939**	**361**	**171**	**238**	**548**	**443**	**182**	**231**	**508**	**379**
1988 TOTAL	1,488	1,110	348	1,456	1,070	386	235	274	575	404	230	266	544	416
1987 TOTAL	1,621	1,212	409	1,535	1,114	421	269	298	634	420	272	282	575	406
6 MONTH AVG. (SAAR)														
1989	1,434	1,087	347	1,350	1,029	329	206	275	560	393	196	260	512	382
1988	1,479	1,137	342	1,422	1,058	364	268	271	562	378	263	266	520	373
1987	1,692	1,267	425	1,617	1,179	438	290	337	628	437	291	317	591	418

HOME SALES

(Units in Thousands)

	EXISTING HOMES			NEW HOMES		
1989	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate
MAR	3,400	2,470	8.7	555	377	8.1
APR	3,400	2,640	9.3	609	377	7.6
MAY	3,210	2,580	9.6	635	381	7.4
JUN	**3,400**	**2,340**	**8.2**	**670**	**379**	**7.0**
1988 TOTAL	3,594	---	---	676	---	---
1987 TOTAL	3,526	---	---	671	---	---
6 MONTH AVG. (SAAR)						
1989	3,407	---	---	632	---	---
1988	3,472	---	---	662	---	---
1987	3,638	---	---	699	---	---

VALUE OF NEW PRIVATE CONSTRUCTION PUT IN PLACE

(Units in Billions of 1982 Dollars, Seasonally Adjusted Annual Rates)

1989	Total[8]	1–Unit	2+ Units	Nonresidential
MAR	$284.2	$101.6	$20.1	$82.5
APR	280.0	99.1	21.5	78.1
MAY	277.7	97.6	19.7	78.9
JUN	**277.6**	**96.1**	**19.5**	**80.9**
1988 TOTAL	281.8	103.5	19.3	77.9
1987 TOTAL	283.0	100.7	22.4	78.2
6 MONTH AVG. (SAAR)				
1989	281.4	100.8	20.0	80.5
1988	278.4	102.9	19.4	78.1
1987	281.1	99.3	23.5	76.1

LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED
By Type of Institution and By Type of Unit

(Dollars in Millions)

	1-4 UNITS					5+ UNITS					NONRESIDENTIAL				
	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies
1989 JAN	$25,691	$5,286	$12,315	$7,689	$72	$2,930	$561	$1,430	$373	$329	$10,425	$121	$1,599	$7,495	$1,146
FEB	22,700	4,494	10,821	7,029	61	2,616	131	1,361	837	67	9,512	38	1,337	6,884	1,151
MAR	29,946	5,990	14,841	8,387	51	2,452	155	1,557	434	142	11,052	63	1,630	7,030	2,086
APR	**27,890**	**5,530**	**13,233**	**8,730**	**85**	**2,480**	**331**	**1,206**	**366**	**221**	**8,897**	**122**	**1,340**	**5,216**	**2,104**
1988 TOTAL	374,401	85,307	186,237	95,474	3,190	37,876	1,526	20,379	6,988	3,553	175,754	1,032	22,953	119,942	29,714
1987 TOTAL	449,544	110,093	208,054	124,551	3,209	41,981	2,409	22,492	8,299	3,547	168,652	2,871	25,613	110,490	28,160
4 MONTH AVG. 1989	26,556	5,325	12,803	7,959	67	2,620	295	1,389	503	190	9,972	57	1,477	6,656	1,622
1988	24,376	6,131	11,670	6,148	101	2,434	243	1,379	418	240	13,837	47	1,720	10,258	1,534
1987	39,513	11,797	16,154	10,951	347	4,314	221	1,634	974	212	11,378	388	1,836	7,447	1,629

MORTGAGE INSURANCE

(Units in Thousands, Dollars in Millions)

	APPLICATIONS RECEIVED (Units)				LOANS INSUR[illegible]							
	TOTAL	FHA[8]	VA	PRIVATE	TOTAL		FHA		VA		PRIVATE	
					Units	Amount	Units	Amount	Units	Amount	Units	Amount
1989 MAR	147	86	16	45	95	$7,142	51	$3,189	18	$1,364	26	$2,589
APR	135	76	15	44	91	6,974	49	3,064	15	1,127	27	2,783
MAY	149	91	15	43	93	7,109	50	3,167	15	1,164	28	2,778
JUN	**157**	**96**	**15**	**46**	**107**	**8,155**	**60**	**3,774**	**14**	**1,072**	**33**	**3,309**
1988 TOTAL	1,755	949	211	595	1,334	98,012	699	42,577	211	15,771	424	39,664
1987 TOTAL	2,340	1,211	408	721	2,282	159,668	1,320	81,881	451	33,312	511	44,475
6 MONTH AVG. 1989	135	80	15	40	100	7,475	57	3,555	16	1,198	27	2,722
1988	154	87	16	51	106	7,634	55	3,298	17	1,240	34	3,096
1987	245	138	42	65	211	14,675	125	7,760	44	3,242	42	3,673

NA—Not Available; SAAR—Seasonally Adjusted Annual Rate

[1] Secondary market gross yields. Numbers shown for each month are the average of yields from the first day of the month shown and the first day of the subsequent month.

[2] Effective rate on loans closed.

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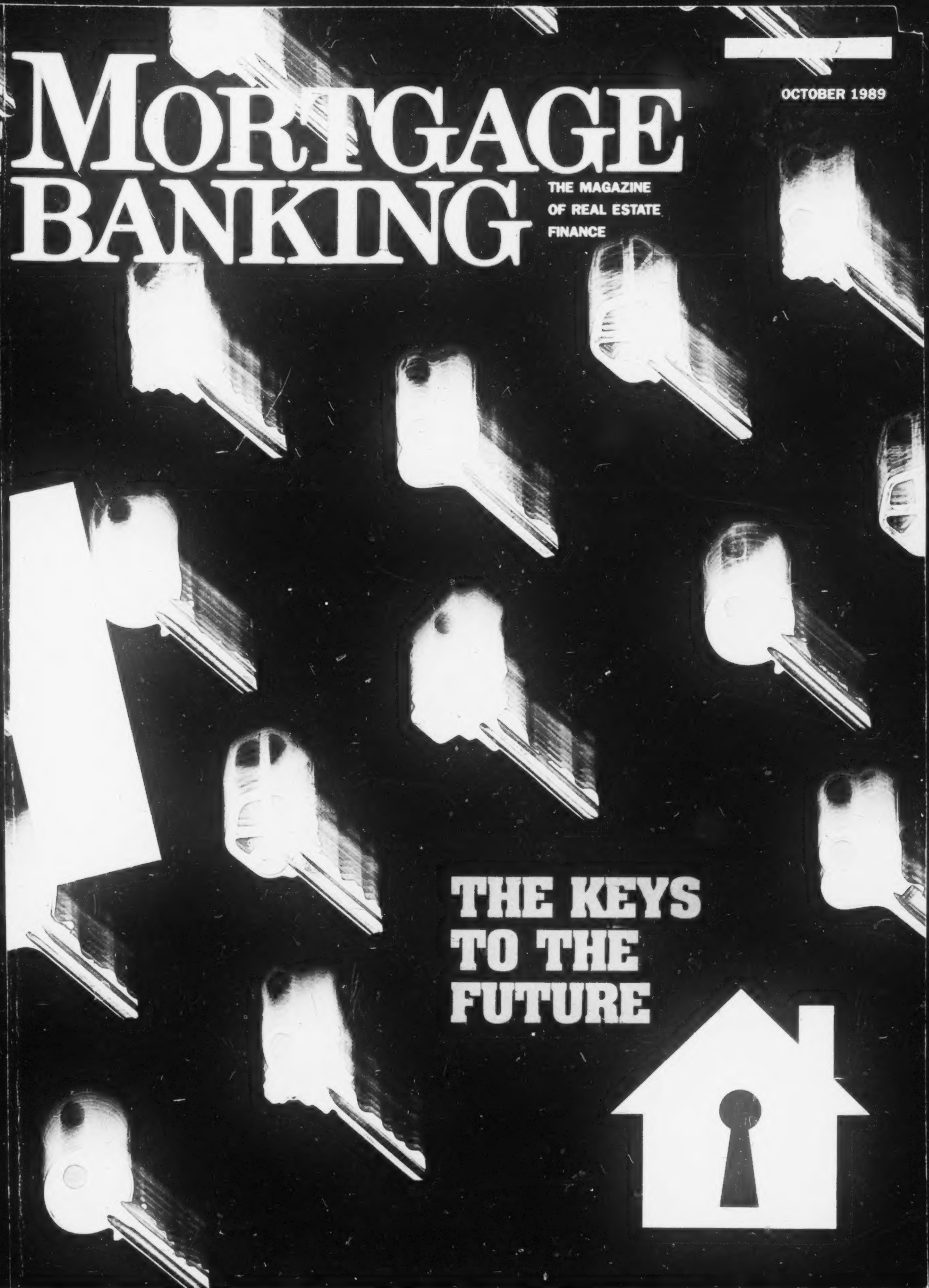


THE KEYS TO THE FUTURE

CONTENTS

OCTOBER 1989 VOLUME 50 NUMBER 1

COVER: Keys to the Future

The future holds no simple answers. There is no single door that will open onto a field of prosperity. Instead, there are many keyholes with many keys to fit them. Each mortgage industry survivor will have to forge its own set of keys to open the now obscured doors leading to future financial success.

18 From Boom to Bust *The transition from the populous baby boom generation to the meager baby bust generation will dramatically shape future housing demand.* By MATHEW H. GREENWALD AND JOHN P. KATOSH

26 Housing's Dark Shadow *In California, many forces are driving up housing prices beyond the reach of the average checkbook. Are the same forces that are now affecting affordability in this market likely to emerge as the norm in other markets?* By HOWARD SCHNEIDER

40 Taking Stock of Housing's Future *Key thinkers, legislators, policymakers and academics chart the biggest problems and opportunities that lie ahead if this nation's great housing promise is to be preserved for all its people.* By JANE MOSS SNOW

49 Toward the Year 2000 *The mortgage banking industry is being reinvented along new dimensions. A look ahead at some of the factors determining the new way of doing business.* By WARREN LASKO

60 The Lomas Lesson *One thing learned by many traditional mortgage bankers is that originations done the old-fashioned way are very costly. This look inside one of the biggest and the best known of the old-line companies offers insights as to how unforgiving the current marketplace is.* By ROBERT STOWE ENGLAND

COVER PHOTOGRAPHY BY ED CASTLE

Financial Bee
Low Housing Demand

Leadership Profile **72** **The Will to Wynn** *A profile of the incoming MBA president reveals a serious competitor with an addiction to sports—particularly Auburn football—and a strong affinity for people* By JANET REILLEY HEWITT

State of the Industry **85** **The Child of Pride** *A roundup of how difficult it was for Houston to face the music when its booming oil-fed economy hit the skids. It was downhill from Governor Connolly's lost art and cattle auction, but denial was the name of the game.* By RICHARD E. WILKES

Legislative **90** **Thrifts—The Next Chapter** *Congress has dramatically rewritten the rules for thrifts. A behind-the-scenes look shows that lawmakers took to the task in anything but a kinder, gentler mood.* By BRIAN COONEY

Regulatory **101** **Claims Audits—More in Store** *Round two of HUD's controversial procedure for auditing the claims its paid to lenders will start next year. Here are some tips on how to defend yourself.* By PHILLIP L. SCHULMAN

Secondary Marketing **110** **Fallout Fallacies** *Mortgage bankers need to take a new look at how they measure pipeline fallout for hedging.* By JOHN McMURRAY, CPA

Servicing **117** **After Pricing, What's Next?** *A manual of the many details involved in a servicing trade after the deal's been struck.* By ALAN R. SKUPP

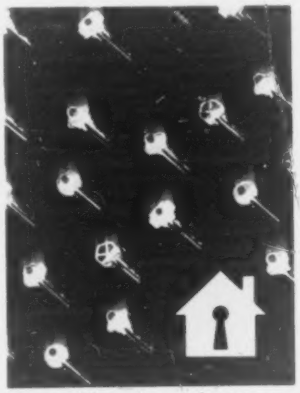
State of the Industry **127** **The Wholesaler's Code** *Words you would like your correspondents to live by written by two major players in wholesale mortgage banking.* By STANNYE W. BARINGER AND JAMES R. LOVING

Management **133** **The Check Is in the Bank** *A review of some ways to get your monthly mortgage payments processed and to the bank faster.* By DONNA RAY-BELCHER

DEPARTMENTS
6 PORTFOLIO
11 BUSINESS ALERT
13 BOARDROOM VIEW
138 PEOPLE
141 THE SECONDARY MARKET
143 ECONOMIC TRENDS
150 INDEX TO ADVERTISERS

PORTFOLIO

Looking through the Keyhole



This month we try to look behind some of the hidden doors through which the industry must pass before arriving at the marketplace of tomorrow. Certainly, some trapdoors exist that might bar the way for those seeking a thriving spot in the next century's housing business environment.

Demographic change is one of those trapdoors. A historic transition between a generation of record numbers—the baby boom—to one of meager numbers—the baby bust—will have a stark impact on housing values and housing demand in the not-so-distant future. The cover story explores how this much smaller generation will shape the type of housing and move-up markets that will retain demand. From our author's account we learn why this financially pragmatic generation will be very different homebuyers than their generational forebears. How this buying behavior plays out will be one key to the future.

Lenders must watch complex social, regional and economic forces, as well as internal industry innovations, to get a reading on what the future will bring. The industry is in the midst of wholesale change. And trees are hard to make out from the middle of the forest. While everyone knows that the working blueprint for the thrift industry was just radically rewritten, what we don't know is how that change will affect mortgage competition on Main Street and open-market pricing for mortgage banking's main commodity—servicing.

Some obstacles blocking the way to a future, well-housed nation can clearly be seen even from the darkness of today's forest. Housing unaffordability—a crisis of growing proportions—is readily apparent in America today. It is a complex problem—the result of a supply/demand equation severely stressed by demographic and economic forces. It is a problem too large for the nation's housing financiers to solve alone. Builders can build and consumers can earn a paycheck, but if the product cannot be priced within reach, there is no housing market working in this country. This problem will clearly still be around in tomorrow's marketplace. And the social fallout from a nation increasingly incapable of purchasing adequate shelter is one trapdoor this nation could do without.

Janet Reilley Hewitt
Editor

COMING IN NOVEMBER

Marketing Mortgage Products

It's a jungle out there. The competition is fierce. The November issue scopes out what some companies are doing to survive. We also explore how HUD survived its own long hot summer.

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Out of these turbulent times will emerge a changed industry. What will it look like?

Toward the Year 2000

Warren Lasko

As we peer over the threshold at the 21st century, the business of financing real estate is in the midst of more rapid restructuring than ever before.

The 1980s opened with interest rates at unprecedented levels. The real estate sector was, as a result, in recession. By mid-decade, sharply lower interest rates and sustained economic expansion led to explosive growth in mortgage financing. Home sales and resales were high; refinancings boomed; and commercial construction and financing set a record pace.

As the decade closed, the mortgage finance industry was retrenching from unsustainable record volume highs. Moreover, the thrift industry was undergoing a massive shakeout and regulatory reform.

The eighties also witnessed a near full maturation of the secondary mortgage market as the mainstream vehicle for financing mortgages. The separate functions of making, marketing, servicing, delivering and trading mortgages became increasingly "unbundled" and specialized in the hands of more narrowly focused firms. Securitization became the norm, not the exception. Global investor distribution networks became the watchword.

This article attempts to translate what's happening in these turbulent and exciting times into meaningful information to help mortgage finance executives plan for the future.

Specific forecasting may be reliable in predicting a future some three or even five years ahead. But beyond that, predictions quickly become meaningless. Really long-run forecasts become sidetracked or are made irrelevant by quantum changes in technology, in political and social affairs and in the rules of the game, all of which are inherently unpredictable.

So, we will merely lay out ranges of possibilities—describe what might happen, not what will happen. As Freeman J. Dyson, in his book *Infinite in All Directions* (Harper & Row, New York, 1987), says: "For the future beyond ten years ahead, science fiction is a more useful guide than forecasting. But science fiction does not pretend to predict. . . . It deals in possibilities, not in probabilities. And the most important developments of the future are usually missed both by the forecasters and by the fiction writers. Economic forecasting misses the real future because it has too short a range; fiction misses the future because it has too little imagination."

Further, the future is different things to different people. There are many things to know—and things cannot be known by a single method or judged by a single standard. The same facts can be arranged in more than one pattern, seen from several perspectives and displayed in many lights.

The mortgage market in recent years has been beset by high and volatile interest rates, the effects of deregulation, excess capacity, huge default and foreclosure losses, intense price competition and the evaporation of profits. There has been a shift from fixed-rate financing toward adjustable rate and other forms of "creative" financing. And there has been a sweeping trend toward securitization and increased reliance on the secondary market.

We recognize we now have a well-developed secondary market that assures the availability of mortgages in bad times as well as good. The secondary market, through Fannie Mae, Freddie Mac and Ginnie Mae, and through a number of private conduits, has proven a remarkably efficient engine for channeling capital for housing from the national and global credit markets into local housing markets.

The marvels of near instant worldwide communication and the ability to transform mortgages into a wide variety of rateable-tradable high-grade securities has made the mortgage market one of the most efficient and competitive marketplaces in existence. Housing consumers have been the beneficiaries. They can compete for housing finance on nearly equal terms with giant corporations and obtain credit at rates only 150 basis points or so above the U.S. government's borrowing costs.

Yet, housing affordability has suffered even as the mortgage market has become more efficient. Home prices in much of the country have risen faster than incomes and faster than the CPI. Young people trying to buy their first home are most affected, as they struggle to accumulate a down payment and to command sufficient income to make a monthly mortgage payment that increasingly looms out of reach for more of them.

Among households headed by persons 25 to 34, the homeownership rate has dropped to about 45 percent, an eight percentage point drop from a decade earlier. The mortgage on a typical home in the late 1980s requires half again as much family income as it did two decades earlier.

The affordability crisis faced by renters is similarly distressing. Higher financing burdens and other costs of owning and operating rental housing have pulled rents up faster than the modest incomes of most renters.

As we look toward the future in our capitalist, free market society, the ultimate driving forces in the housing sector and elsewhere will remain profits and returns on investments. The future of real estate finance will be shaped by the combined forces of entrepreneurship, human ingenuity and technology. These forces will be at work armed with capital by those in pursuit of material gain but guided and restrained by public policy and regulation.

The way we finance housing and other real estate in the 21st century will almost certainly provide better mortgage products, more efficiently, at lower real costs. The competitive forces of the free marketplace work inexorably toward innovation and greater efficiency over the long term. Our business, like most, will do thousands of little things a little bit better, and once in a while a very few things a whole lot better.

Basic demand for mortgage finance

There will be a large and growing market for real estate finance, but it will be a leaner, less ebullient business than in the 1980s.

There will always be a need and therefore demand for housing, office and other commercial space, and for the financing of it. But the rate of growth in demand has reached a plateau and will even slacken a bit nationwide during the 1990s. Chart 1 shows net new household formations declining from an annual average of 1.6 million in the 1980s to 1.2 million in the 1990s. This will translate into an average annual need for some 1.4 million housing unit starts. That in turn suggests fewer new home sales and sharply lower multifamily construction.

Interestingly, existing home sales will rise gradually. Though the absolute number of additional new homes will be declining, the total stock of housing will be rising and so too will the number of existing units sold each year.

This less than roaring housing market and related employment and commercial activity will in turn generate only slowly growing and still cyclical needs for mortgage credit. We anticipate that home mortgage originations during the 1990s will average slightly more than $500 billion a year.

We expect loan servicing, by contrast, to continue growing. By the year 2000, home mortgage debt will likely reach $6 trillion. This is far more than double its level at the start of the 1990s. See Chart 2.

Demographics could play a beneficial role in lowering mortgage and other interest rates in the 1990s. As the bulge in the U.S. population grows older, it will shift over the next decade from credit-using, nonsaving young people to credit-supplying net savers.

This population shift almost certainly will be accompanied by diminished market share for first-time home

CHART 1. Housing Markets in the 1990s

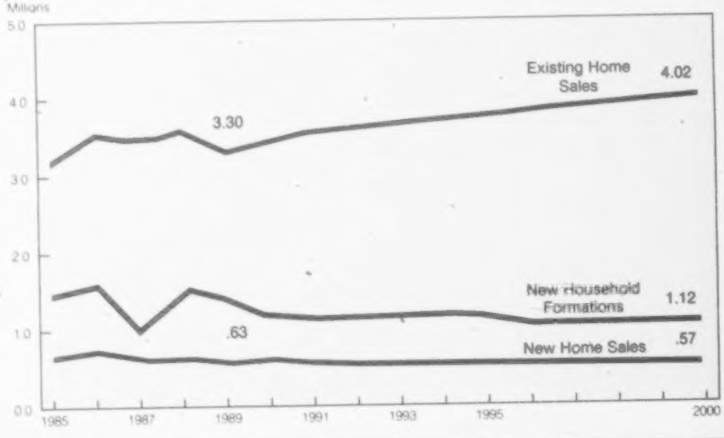
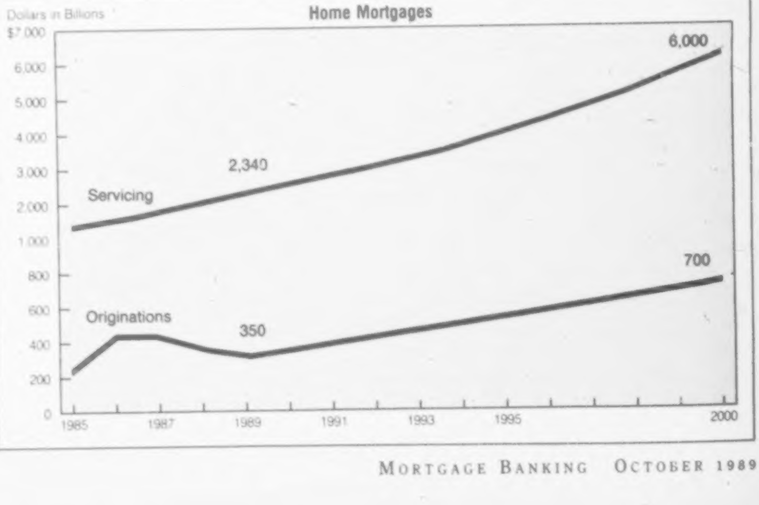


CHART 2. Mortgage Finance in the 1990s



buyers and the use of low down payment, conventional, FHA and VA mortgages. The move-up market for housing and mortgages will grow in importance, suggesting comparatively strong demand for high-balance, conventional, nonconforming financing.

Structure of the industry

Who will make, service and hold mortgage debt? As we enter the 1990s, the entire financial services and mortgage delivery system is going through a period of fundamental restructuring.

Consider first who will likely be the ultimate investors. Where will mortgage money come from? It used to be, at the beginning of the 1980s, that savings institutions and banks provided most of it. Indeed, the thrift industry alone held about half of all mortgage debt then. But as the decade ends, thrifts hold a much lower portion of the total, and their share is declining (Chart 3).

Meanwhile banks, pension and insurance funds and foreign institutions are becoming far more important as ultimate sources of mortgage funds. This trend will accelerate. Pension funds, without doubt, will grow in importance.

> *In terms of who will play what role in the mortgage market of the future, there is a paradox evolving. There is under way an homogenization of institutions on a global scale, but at the same time there is also a growing specialization of functions within firms.*

In terms of who will play what role in the mortgage market of the future, there is a paradox evolving. There is under way an homogenization of institutions on a global scale, but at the same time there is also a growing specialization of functions within firms.

In the time-worn fashion of progressing through stages of specialization and division of labor, we envision the mortgage business becoming divided into separate, more efficient entities. The specialized business niches will be:

- Originating (or making) mortgages, including underwriting and quality control;
- Aggregating (or pooling) and warehousing mortgages, making them ready for delivery into the secondary market;
- Marketing and risk management prior to delivery to investors;
- Wholesale distribution to the investment community, and subsequent trading, along with the reconfiguration of cash flows into derivative products;
- Mortgage loan administration;
- Mortgage insurance and other credit enhancement functions;
- Holding mortgages and related securities as investors.

These functions will often be carried out within the same company, but need not be. Banks and thrifts that hold uninsured conventional loans in portfolio do all of these activities in-house. But low-cost/high-efficiency specialists will increasingly take on the individual functions.

The making and servicing of mortgages will continue to be the province of mortgage companies, banks and thrift institutions. Mortgage companies will prosper when they can take advantage of their total specialization in mortgages, their agility and their ingenuity as low-cost providers and servicers of mortgage products.

Thrifts and banks likely will converge and will fall into two, perhaps three, categories. Some will remain small scale, essentially consumer lenders. These will have a special role emphasizing mortgages in towns and communities where personal relationships remain important and price is not the determining factor.

At the extreme, some institutions will be so huge as to be almost impossible to define. Citicorp and American Express come to mind. They will have large market shares in the mortgage arena. Their success in the mortgage arena will be augmented by their name, scale and corporate presence; but a more vital question will be whether they can muster the ability to motivate and maintain entrepreneurial autonomy in a separate, mortgage-specialized subsidiary within the overall corporate structure.

Consider now the possibilities in the

CHART 3. Who Makes, Services and Holds Home Mortgage Debt? (Dollars in Billions)

	1980		1988	
	Amount	Percent	Amount	Percent
Mortgage Originations				
Thrifts	$ 66.5	49.7%	$ 186.2	49.7%
Mortgage companies	29.4	22.0	85.3	22.8
Commercial banks	28.8	21.5	95.5	25.5
All others	9.1	6.8	7.4	2.0
Total	$133.8	100.0%	$ 374.4	100.0%
Mortgage Servicing				
Thrifts	$482.0	50.4%	$ 823.8	38.9%
Mortgage companies	195.0	20.4	748.8	35.4
Commercial banks	179.1	18.7	402.2	19.0
All others	100.2	10.5	140.4	6.7
Total	$956.3	100.0%	$2,115.2	100.0%
Mortgage Holdings*				
Thrifts	$512.0	53.5%	$ 924.8	43.7%
Commercial banks	196.6	20.6	482.5	22.8
Pension and retirement funds	27.3	2.9	135.9	6.4
Federally chartered agencies	38.0	4.0	131.8	6.2
Insurance companies	28.2	2.9	143.0	6.8
All others	154.2	16.1	297.2	14.1
Total	$956.3	100.0%	$2,115.2	100.0%

* Including mortgage-backed securities

key traditional functions of mortgage finance—making, marketing and servicing mortgages.

The origination function

At no place in the mortgage market is the competition keener than in loan production. It will remain so. The business of producing mortgages will face the continuing challenges of: gaining efficient access to the consumer—the borrower—both directly and through real estate agents, while controlling costs and adapting automation and other new technology to speed and simplify mortgage lending.

Coupled with the ease of entry into the business and the tendency toward overcapacity, these forces will keep pressure on loan pricing for the foreseeable future.

The most successful firms in the 1980s were those that controlled costs most effectively. With demographics weakening and capacity excessive, intense price competition will mean that successful firms in the future will be leaner and even more tightly managed in the years ahead.

Economies of scale exist to a far lesser extent in loan production than in servicing. The annual volume of loan production needed to achieve profitability in a well-run firm will likely remain low. Indeed, diseconomies may set in above fairly modest production levels. So, relatively small, well-managed firms can prosper, particularly in so-called niche markets with niche products. Overall, there will be continuing moves toward reduced branch office overhead, "shirt-sleeve" rather than "managerial" employees, controls on excessive compensation packages, and consistently sound underwriting and systemwide quality controls.

The 1990s could well witness the emergence of the loan-originating correspondent firm, replacing the branch office network, as the predominant source of loan originations. Independent correspondents can be so efficient, move so fast, operate with such low overhead and enter or leave a volatile market so easily ("they pop up like mushrooms after a rainstorm") that they may render traditional branch offices obsolete in cost-price competitive markets. Risk management and quality control will be keys to long-term success among wholesale purchasers from such correspondents.

Intense price competition will mean that successful firms in the future will be leaner and even more tightly managed in the years ahead.

Expect in the decade ahead a trend toward the global standardization of mortgage products. Consumer desires and preferences all over the world are becoming more homogeneous.

The marketing function

At the heart of mortgage banking is the process of delivering, or marketing, mortgages into the secondary market. This function almost without doubt will become even more integral to the business of mortgage lending in the decade ahead.

And, central to the marketing function is maximizing profit in a framework of risk management. This will be as true in the future as in the past. We may not be able to forecast the level of interest rates, but we know they'll be volatile. It's a fact of life.

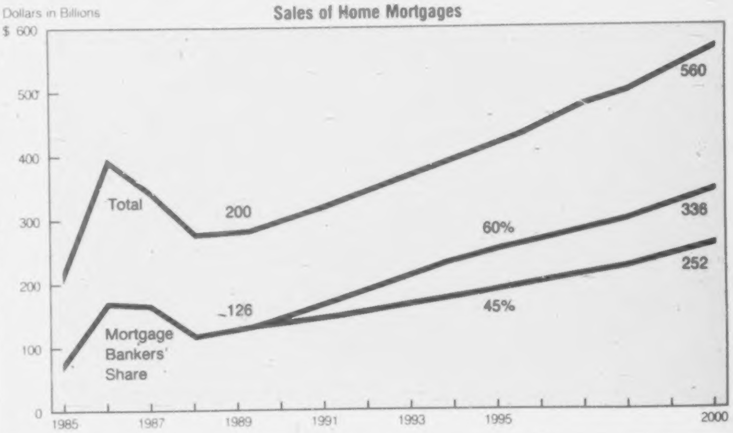
We can anticipate a continued search for better hedging vehicles and attempts to further shorten the period from loan application to delivery. There will almost certainly be advances in securitizing ARM loans, and these will become more readily accepted in the investor community. Other new products likely will involve securities with global appeal—for example, LIBOR-based floaters, with strip features and advances in reducing exchange rate risk.

While there well may be some further refinement in CMO structures, there is only a limited likelihood of any further quantum leaps in the technology of rearranging mortgage cash flows. Certainly the marketing function, more than any other part of the mortgage business, will be heavily dependent on computers, information processing and electronic communications. And it will be driven by intense competition based on price, not on personal relationships. This indeed may be the single biggest revolution over the past two decades in the way the mortgage business is conducted.

Loan originators and servicers will relate to the marketing function in different ways based mainly on their size. Small firms will deliver to wholesalers, which in turn will aggregate loans and perform most of the risk management and marketing functions.

The very largest servicers will increasingly issue REMICs directly, while most firms will continue to rely on the federal agencies and private

CHART 4. Secondary Market Activity in the 1990s



conduits for the securitization of their loans. Even the large private issuers will be constrained by the capacity of their corporate parents to carry the contingent liability of huge volumes of mortgage-backed securities.

The accompanying Chart 4 shows our projection that by the year 2000 home mortgage sales into the secondary market will reach about $560 billion. This will represent about 80 percent of loan originations. Mortgage bankers can be expected to be the principal players in delivering new mortgages into the secondary market. If they do no more than maintain their current market share of 45 percent, they will be selling more than $250 billion in loans by the beginning of the 21st century.

The servicing function

In loan administration, automation advances coupled with competitive forces will move the break-even level of real costs ever lower. The minimum volume of residential servicing needed to sustain profitability, probably in the range of 30,000 to 50,000 loans in the late 1980s, will continue to rise.

Hence the minimally optimal servicing operation will likely be far larger than the comparable scale of an efficient production operation. As a result, bulk servicing purchases will become a routine, institutionalized part of the mortgage business.

In servicing, the point where the most dramatic economies of scale were activated shifted from perhaps as low as 10,000 loans early in the decade to the 50,000 loan range late in the decade.

As direct servicing costs—people, data processing and the like—are brought down further, the 1990s will see a growing emphasis on controlling credit losses and contingent liabilities that are becoming more and more a part of the mortgage business.

Specialization

There probably is no one "ideal" mortgage firm. The consensus today is that small firms specializing in production have a viable place in the future. But to survive in the servicing business, you will have to be big and get bigger.

Midsize firms trying to perform as producers and servicers face a dilemma. They will be squeezed by the smaller producing firms' ability to contain costs and compete aggressively in local markets and by the economies of scale of larger servicers.

> *The future may see CEOs closer to, not further away from, the origination, servicing and administrative processes at both an operational and a leadership level.*

These basic and differing economies of loan production and loan servicing point toward a continuing bifurcation of these two businesses. This prospect is heightened by tax and accounting rules. The ability to amortize purchased servicing, but not the servicing your firm originates, reduces current tax liabilities for firms that purchase servicing.

This strong combination of real economies plus tax incentives, if they continue, almost guarantees the continuance of huge amounts of servicing transfers. It also virtually assures the growth, further evolution and institutionalization of loan transfer mechanisms. This trend is reinforced by the fact that sales of servicing have become a tool to manage quarterly earnings.

To link separate production and servicing functions, correspondent-wholesaler networks have emerged. These networks have become an integral part of the engine that transforms highly differentiated individual mortgage products into homogeneous securitized investments.

Size of firms

While the smallest practical scale for a profitable servicing operation will continue to grow, the threshold of a successful loan administration department will remain low enough that there will be room for a good number of companies in the industry.

In a $6 trillion-plus servicing market, in which most economies of scale are achieved by the time you reach the $5 billion to $10 billion range, there is room theoretically for 100 or more major firms. That number grows if you believe that diseconomies set in at some point. "A penalty of size is that you try to do everything, and no one can do everything well," says Peter Drucker. Large companies emphasize quantity not quality, have costly extra layers of managements and respond slowly to changing market conditions.

In a global market, bigness could even be a handicap. Such a market demands features unrelated to bigness. It requires speed, agility and savvy. Even large firms can be expected to rely more on lean, decentralized decision making, small and flexible operating units and subcontracting.

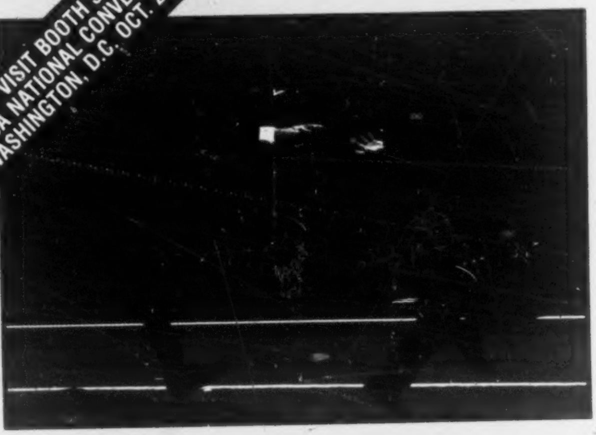
Designing your firm's future

Tomorrow's executives face the ongoing challenges of developing and managing a product mix, a network for loan production and a distribution system. But also they must design, build and maintain their corporate entities—their concepts of organization suited to the business and competitive environment of the 1990s and beyond.

The marketplace and the consumers of our products will care not a whit how we structure ourselves. They are simply looking for a mortgage at the lowest cost with reasonably good service. Chief executive officers find themselves nonetheless in charge of firms and a seemingly incredible menu of possibilities as to their mission, core purposes and how to organize them.

The organizational concepts of business are changing. In the mortgage lending business as in much of American enterprise, the classical form of organizational structure with its layers and lines of authority may be obsolete. The future may see CEOs closer to, not further away from, the origination, servicing and administrative processes both at an operational and a leadership level.

The profit margins in each aspect of the business have been permanently reduced. We have seen beyond a doubt that the most successful firms are those that control costs at every stage of the business. Thus the focus of successful leadership will be on the per unit cost of producing the firm's total



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product; the entire organization must be woven as a single fabric that achieves utmost productivity—or in other words, minimum costs.

How does one begin to plan for the future in such a rapidly changing world? Every company starts from where it is now. It starts with the hand it's been dealt: its size, capital, employees, location, product mix and customer base. Its business and political environment is essentially the same as everybody else's. The important and in fact essential first step in determining your own destiny is to have a plan—to know what it is you can do and want to do. As Lee Iacocca says, "The discipline of writing something down is the first step toward making it happen."

A plan begins with understanding the setting in which a firm finds itself, establishes a straightforward mission statement, which in turn is refined into specific long-term goals and shorter term activities with concrete objectives.

Probably the next most important step in designing your firm's future is to tell people about it. For an organization to function as a single, purposeful body, it needs an integrated planning-management system that everyone in the company understands.

In communicating or projecting the vision of one's firm, the top executive starts off with some very positive "givens." People in the mortgage business are in the housing and community-building business—serving basic human needs for shelter and decent surroundings. Unlike the uncertain need or demand for many other products, there will always be a genuine, fundamental need for housing and places to work, shop and play, and for the need to finance it.

Our industry is one of the most competitive in the world. So we are constantly forced to innovate and to deliver quality products at the lowest possible prices. We are a flexible, adaptive industry, nonunionized and, unlike much of the rest of American industry, relatively untouched by competition from abroad. These all are characteristics that will work in favor of our industry in meeting the challenges that lie ahead. **MB**

Warren Lasko is executive vice president of Mortgage Bankers Association of America.

ECONOMIC TRENDS

With the troubles of 1987 more than just a vivid memory, many mortgage companies are still striving to improve productivity and contain costs. Over the past 1½ years the results of those efforts have been encouraging, but somewhat mixed. MBA's Ratio Analysis Survey (RAS) for the second quarter of 1989 indicates that servicing volume continues to rise while servicing expenses are moving downward. However, origination volume has been rather soft thus far this year, and costs remain stubbornly high. (The discussion that follows is based on data obtained from 18 companies that participated in the RAS in both the second quarter of 1988 and the second quarter of 1989.)

To achieve these belt-tightening objectives, many firms have consolidated their operations and introduced newly available technology into the workplace. A trend in loan production has been to close or merge origination offices and to further centralize underwriting and processing. In servicing, the focus has been on implementing cost-saving computer applications, as well as better loan quality control.

The most noticeable byproduct of these efforts has been the significant reduction in staffing levels at many mortgage companies. Between the second quarter of 1988 and the second quarter of 1989, the number of full-time equivalent employees fell by about 15 percent, or 45 employees per firm. The declines were widespread, with the number of origination employees falling by an average of 12 employees per firm, and the number of servicing employees dropping by an average of 8 employees per firm. Large staffing declines also occurred in areas other than origination and servicing.

In servicing, the mainstay of most mortgage companies, these decreases in employment have been the outgrowth of substantial increases in productivity. In fact, over the course of the year, the number of loans serviced per servicing employee jumped 23 percent, or 137 loans, from 587 loans in the second quarter of 1988 to 724 loans in the second quarter of 1989.

In turn, this rise in productivity has fostered a large drop in direct servicing costs. Although these costs remain quite high because of unusually large expenses for problem loans, servicing costs actually fell by 11 percent over the past year. At an annual rate, servicing expenses per-loan-serviced in the second quarter of 1988 were $103; by the second quarter of 1989, they were down to $91.

Data-processing costs associated with single-family servicing also dropped by 13 percent. At an annual rate, data-processing expenses per-loan-serviced were $9.48 in the second quarter of 1989. With servicing volume expected to continue rising, further gains in productivity could lower costs and improve profitability.

By contrast, direct origination costs per loan closed rose by 25.5 percent. Rising from $1,328 in the second quarter of 1988, these costs jumped to $1,666 in the second quarter of 1989. Even though origination staffs have been reduced, lending volume fell even more sharply during this period. Consequently, the number of loans closed per origination employee fell by 25 percent, from an annual rate of 36 loans in the second quarter of last year to an annual rate of 27 loans in the second quarter of this year.

The decline in lending volume noted in this survey is consistent with industrywide data showing that through May 1989, mortgage bankers' one- to four-unit lending volume was substantially lower than during the same period in 1988. However, with the earlier downward drift in mortgage rates expected to continue, mortgage bankers' lending volume should rise during the second half of the year.

On the whole, despite the rise in origination costs, two key measures of profitability showed marked improvement in the second quarter of 1989, relative to the same period last year. Return on average equity increased 58 percent to an annual rate of 8.20 percent, and return on average assets rose by 62.50 percent to an annual rate of 1.04 percent. While these figures are still below historical norms, the trend is clearly upward.

Data from the RAS is quite useful in tracking current developments in the mortgage banking industry. Additional member firms that would like to participate in this quarterly survey are welcome. Reporting is relatively easy, and the results are routinely distributed shortly after the end of each quarter via the ECHO system or in a typed report. For further information, contact Rick Murray, Programmer/Analyst, MBA Economics Department, at (202) 861-1941.

Robert Rosenblatt
Economist
MBA Economics Department

Mortgage Banking Industry Quarterly Productivity and Cost Ratios (18 Repeat Reporters)

	Second Quarter 1988	Second Quarter 1989	Percent Change
Productivity Measures:			
Single-Family Loans Closed Per Origination Employee	36*	27*	−25%
Single-Family Loans Serviced Per Servicing Employee	587	724	23%
Cost Measures:			
Direct Cost of Originating a Single-Family Loan	$1,328	$1,666	25%
Direct Cost of Servicing a Single-Family Loan	$102.52*	$90.92	−11%

* Annual Rate

VITAL STATISTICS

INTEREST RATES & YIELDS

1- TO 4-FAMILY MORTGAGES

	FHA OPINION SURVEY	FHLBB			FNMA		FHLMC	
		CONVENTIONAL^{2}						
1989	FHA New Homes^{1}	FRM	ARM	Median Cost of Funds FSLIC Institutions	1-Yr. ARM	FRM Conv.	ARMs	FRMs
MAY	10.72%	11.14%	9.74%	7.99%	9.46%	10.55%	9.30%	10.77%
JUN	10.32	11.03	10.03	8.01	8.73	9.98	9.03	10.20
JUL	9.85	10.66	9.84	8.07	8.24	9.72	8.74	9.88
AUG	**NA**	**10.33**	**9.57**	**NA**	**9.95**	**8.40**	**8.65**	**9.99**

SELECTED SECURITIES

		PRIME COMMERCIAL PAPER	U.S. GOVERNMENT				
1989	FEDERAL FUNDS RATE	(3-Month)	6-Month	1-Year	3-Year	10-Year	A-Rated Utility
MAY	9.81%	9.47%	8.41%	8.98%	8.98%	8.86%	10.09%
JUN	9.53	9.11	7.93	8.44	8.37	8.28	9.65
JUL	9.24	8.68	7.61	7.89	7.83	8.02	9.54
AUG	**8.99**	**8.57**	**7.74**	**8.18**	**8.13**	**8.11**	**9.55**

CURRENT SECONDARY MARKET YIELDS

SPREADS

(Basis Points)

1989	GNMA^{3}	FNMA^{3}	FHLMC^{3}	GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
MAY	10.29%	10.31%	10.30%	143	145	144
JUN	9.72	9.76	9.74	144	148	146
JUL	9.44	9.47	9.48	142	145	146
AUG	**9.49**	**9.53**	**9.53**	**138**	**142**	**142**

SECONDARY MARKET ACTIVITY

(Dollars in Millions)

	FNMA				FHLMC				GNMA	
	Portfolio		Mortgage-Backed Securities						Pass-Through Securities	
1989	Commitments	Purchases	Out-Standing	Issued	Commitments To Sell	Commitments To Buy	Mortgages Purchased	PCs Issued	Applications	Issued
APR	$1,118	$1,163	$191,420	$4,407	$5,945	$4,196	$5,861	$5,554	$3,513	$3,983
MAY	1,626	1,419	193,681	3,762	5,233	5,186	5,141	4,474	4,452	4,115
JUN	2,573	1,862	196,501	4,339	7,753	7,948	7,392	6,551	3,267	4,138
JUL	**2,513**	**2,091**	**–**	**5,464**	**5,934**	**6,609**	**5,720**	**5,180**	**4,395**	**4,895**
1988 TOTAL	23,435	23,110	---	54,878	41,271	70,669	44,075	39,777	58,578	56,531
1987 TOTAL	25,415	20,531	---	63,230	68,210	76,615	76,840	75,018	116,611	96,983
7 MONTH AVG. 1989	2,035	1,421	---	4,619	5,979	6,969	5,596	5,158	4,011	4,230
1988	2,368	2,221	---	4,198	2,826	5,369	3,148	2,702	4,341	4,279
1987	1,960	1,550	---	6,036	7,549	8,209	8,313	8,155	11,916	9,629

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES

(Units in Thousands, Seasonally Adjusted Annual Rates)

	BY TYPE OF UNIT						BY REGION							
	HOUSING STARTS			BUILDING PERMITS			HOUSING STARTS				BUILDING PERMITS			
1989	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units	Northeast	Midwest	South	West	Northeast	Midwest	South	West
MAY	1,308	1,019	289	1,347	970	377	176	244	513	375	179	245	528	395
JUN	1,406	1,027	379	1,308	940	368	168	242	552	444	177	234	506	391
JUL	1,424	1,086	338	1,281	979	302	195	267	532	430	160	232	478	411
AUG	**1,353**	**1,061**	**292**	**1,326**	**993**	**333**	**140**	**241**	**574**	**398**	**168**	**272**	**521**	**365**
1988 TOTAL	1,488	1,140	348	1,456	1,070	386	235	274	575	404	230	266	544	416
1987 TOTAL	1,621	1,212	409	1,535	1,114	421	269	298	634	420	272	282	575	406
8 MONTH AVG. (SAAR)														
1989	1,423	1,084	339	1,339	1,007	333	195	270	558	400	188	259	509	385
1988	1,473	1,134	338	1,427	1,063	363	259	274	562	384	252	263	529	383
1987	1,666	1,246	420	1,591	1,157	434	284	319	630	434	285	302	588	416

HOME SALES

(Units in Thousands)

VALUE OF NEW PRIVATE CONSTRUCTION PUT IN PLACE

(Units in Billions of 1982 Dollars, Seasonally Adjusted Annual Rates)

	EXISTING HOMES			NEW HOMES						
1989	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate	Total[a]	1-Unit	2+ Units	Nonresidential
APR	3,400	2,640	9.3	607	377	7.6	$280.0	$99.1	$21.5	$78.1
MAY	3,210	2,580	9.6	646	381	7.3	278.2	97.5	19.7	78.8
JUN	3,360	2,350	8.4	646	379	7.3	277.3	95.8	19.6	79.7
JUL	**3,400**	**2,320**	**8.2**	**739**	**371**	**6.1**	**277.1**	**95.4**	**19.1**	**80.2**
1988 TOTAL	3,594	---	---	676	---	---	281.8	103.5	19.3	77.9
1987 TOTAL	3,526	---	---	671	---	---	283.0	100.7	22.4	78.2
7 MONTH AVG. (SAAR)										
1989	3,400	---	---	645	---	---	280.8	100.0	19.9	80.3
1988	3,497	---	---	667	---	---	278.6	102.7	19.4	77.9
1987	3,614	---	---	695	---	---	280.9	99.4	23.2	76.4

LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED
By Type of Institution and By Type of Unit

(Dollars in Millions)

	1-4 UNITS					5+ UNITS					NONRESIDENTIAL				
	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies
1989 FEB	$22,700	$4,494	$10,821	$7,029	$61	$2,616	$131	$1,361	$837	$67	$9,512	$38	$1,337	$6,884	$1,151
MAR	29,946	5,990	14,841	8,387	51	2,452	155	1,557	434	142	11,052	63	1,630	7,030	2,086
APR	27,890	5,530	13,233	8,730	85	2,480	331	1,206	366	221	8,917	122	1,340	5,216	2,104
MAY	**29,269**	**5,302**	**13,270**	**10,179**	**132**	**2,290**	**286**	**981**	**640**	**166**	**13,301**	**186**	**1,476**	**8,404**	**3,094**
1988 TOTAL	374,401	85,307	186,237	95,474	3,190	37,876	4,526	20,379	6,988	3,553	175,754	1,032	22,953	119,942	29,714
1987 TOTAL	449,544	110,093	208,054	124,551	3,209	44,981	2,409	22,492	8,299	3,547	168,652	2,871	25,613	110,490	28,160
5 MONTH AVG. 1989	27,099	5,320	12,896	8,403	80	2,554	293	1,307	530	185	10,641	106	1,476	7,006	1,916
1988	26,160	6,360	12,640	6,698	131	2,597	241	1,431	511	256	14,400	47	1,750	10,566	1,788
1987	41,062	12,040	17,231	11,225	304	4,242	188	1,691	870	236	11,899	357	1,876	7,823	1,764

MORTGAGE INSURANCE

(Units in Thousands, Dollars in Millions)

	APPLICATIONS RECEIVED (Units)				LOANS INSURED							
	TOTAL	FHA[8]	VA	PRIVATE	TOTAL		FHA		VA		PRIVATE	
					Units	Amount	Units	Amount	Units	Amount	Units	Amount
1989 APR	135	76	15	44	91	$6,974	49	$3,064	15	$1,127	27	$2,783
MAY	149	91	15	43	93	7,109	50	3,167	15	1,164	28	2,778
JUN	157	96	15	46	107	8,155	60	3,774	14	1,072	33	3,309
JUL	**153**	**92**	**14**	**47**	**94**	**7,411**	**48**	**3,060**	**13**	**985**	**33**	**3,366**
1988 TOTAL	1,755	949	211	595	1,334	98,012	699	42,577	211	15,771	424	39,664
1987 TOTAL	2,340	1,211	408	721	2,282	159,668	1,320	81,881	451	33,312	511	44,475
7 MONTH AVG. 1989	137	81	15	41	99	7,466	56	3,484	15	1,168	28	2,814
1988	153	85	16	52	109	7,909	57	3,453	17	1,246	35	3,210
1987	238	131	41	66	212	14,706	124	7,701	44	3,204	44	3,801

NA—Not Available; SAAR—Seasonally Adjusted Annual Rate

[1] Secondary market gross yields. Numbers shown for each month are the average of yields from the first day of the month shown and the first day of the subsequent month.

[2] Effective rate on loans closed.

[3] Securities for 0 to 30 day delivery.

[5] In addition to the categories of private construction shown, the total also includes these categories: residential improvements, railroads, electric light and power, gas, telephone and telegraph, petroleum pipelines, and farm nonresidential.

[6] In addition to the categories shown, the total also includes private pension funds, private MBS conduits, state and local retirement funds, Federal credit agencies, mortgage pools, and state and local investment agencies.

[7] Savings & Loans and Mutual Savings Banks.

[8] FHA applications received includes the Direct Endorsement Program.